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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, ~~1929~~ 1930

No. ~~710~~ 60

J.G. Denman, Administrator &c.

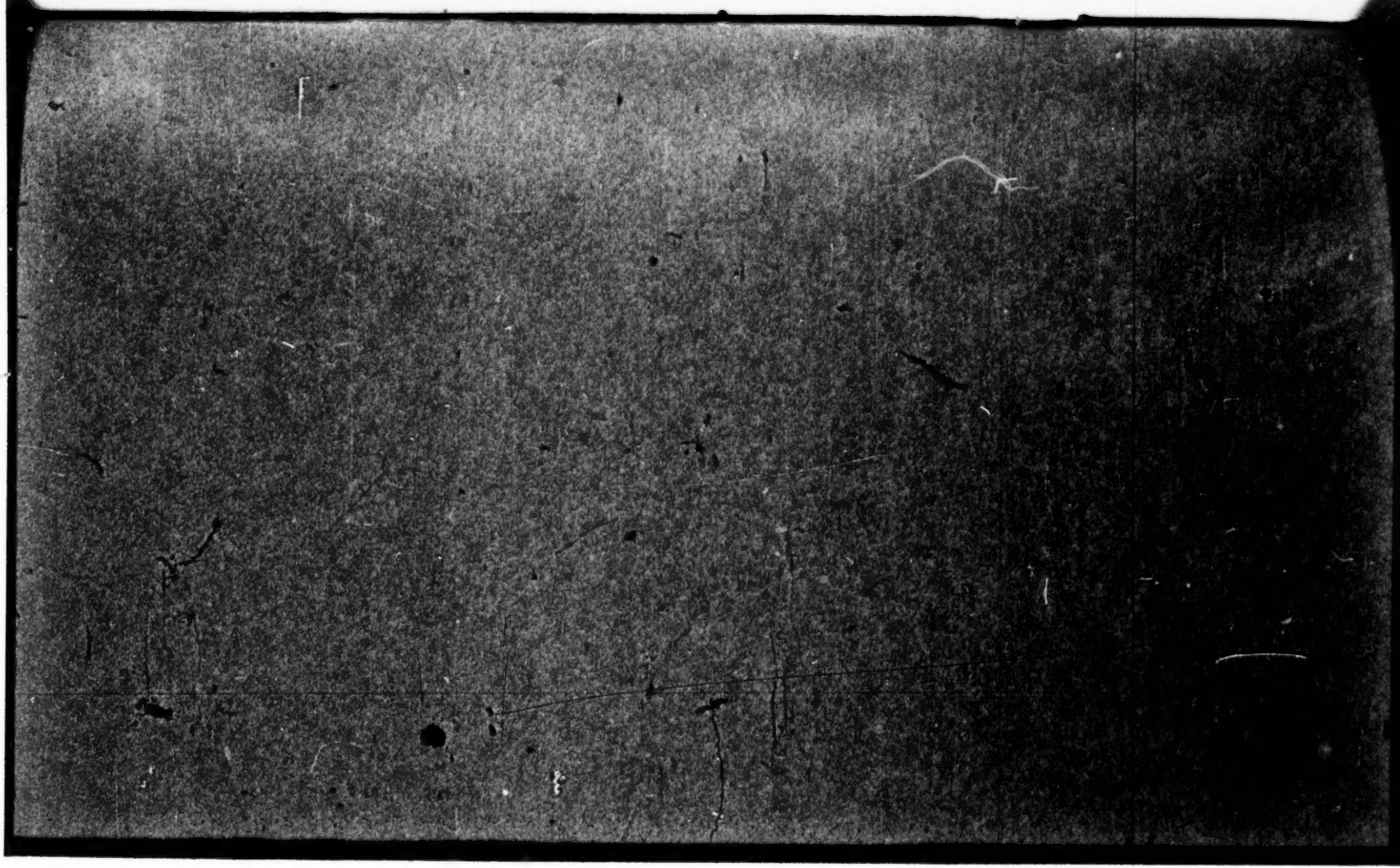
CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

W. L. SLAYTON

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 6, 1930
CERTIORARI GRANTED APRIL 28, 1930



SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929

No. 719

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

W. L. SLAYTON

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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1 In the United States District Court, Northern District of Ohio, Western Division

[Caption omitted.]

W. L. SLAYTON, PLAINTIFF vs. CHAS. H. NAUTS, COLLECTOR OF INTERNAL REVENUE, defendant	In Law. No. 3428

2 *Petition*

Filed Aug. 10, 1928

W. L. Slayton, plaintiff, a resident of Toledo, Lucas County, Ohio, respectfully represents:

(1) The defendant, Charles H. Nauts, is and at the times hereinafter mentioned was the United States internal revenue collector for the tenth district of Ohio, which includes the City of Toledo, Ohio.

(2) This suit arises under the revenue laws of the United States, the amount involved, exclusive of interest and costs, exceeds the sum of $3,000.00.

(3) The plaintiff is now and at the times herein mentioned was engaged individually in the business of buying, selling, and dealing in bonds—particularly municipal bonds—under the name of "W. L Slayton & Company" and has at all times kept his books on an accrual basis.

(4) In the operation of his bond business in 1922, it was necessary to and the plaintiff did borrow money and pay interest thereon for the purpose of purchasing, carrying, and selling notaxable securities, namely, municipal, county, and State bonds. The amount of interest so paid was $78,152.84.

(5) During the year 1922 plaintiff's net income—excluding $65,720.06 tax-exempt interest received from municipal bonds owned by the plaintiff—which was legally taxable under the sixteenth amendment of the United States Constitution was $28,551.94. Plaintiff, making his return for 1922 as required by law, deducted from his gross income the $78,153.84 which he had paid for and in the purchase, carriage, and sale of nontaxable State, county, and municipal bonds as shown in paragraph 4 hereof. Without this deduction and as claimed by the defendant, the plaintiff's net taxable net income would have been $106,704.78. This made a difference in tax and interest of $40,429.53 which is the subject matter of this suit.

(6) Thereafter the internal revenue agents of the United States made examinations of the plaintiff's books and return and made reports dated November 4th, 1926, and February 27th, 1927, as a result of which the deduction of said interest sum, $78,152.84, which had been made by the plaintiff in his return, was disallowed

3 and that amount was added to the plaintiff's net taxable income and an additional tax thereon of $32,606.49 was proposed and said additional tax was thereafter assessed.

(7) Thereafter defendant gave notice and made demand upon plaintiff for payment, which notice and demand stated that if payment was not made within ten (10) days a penalty of 5% of the amount of the tax together with interest at the rate of 1% per month until payment was made would be added, both of which additions were provided for in the act. Said notice also stated that unless said tax was paid within ten (10) days, restraint for the collection of the tax, the additional penalty, and interest would be made.

(8) On August 4th, 1927, the plaintiff, in order to avoid such severe penalties provided for by said act, involuntarily and under written protest, paid to the defendant the sum of $40,384.53, consisting of such additional tax of $32,606.49 and interest amounting to $7,778.04.

(9) On November 23, 1921, Congress passed an income tax law known as the "revenue act of 1921." The United States Government might not then and may not now constitutionally tax the means and instrumentalities of the several States of the United States nor could it tax the income from State or municipal bonds. Aware of this constitutional limitation, Congress, in formal or pretended compliance therewith, in section 213 of the act and in subdivision (b) in paragraph 4 thereof provided for the exemption from such tax of all income from State or municipal bonds by providing in the last-mentioned part of the act for the exclusion from gross income of "(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof."

In the same act and to avoid or nullify the above-shown provisions for the pretended exemption of said municipal bonds from taxation, Congress, in section 214 (a) and 214 (a) (2), unconstitutionally attempted to tax such nontaxable bonds indirectly by providing that interest paid by the taxpayer on account of indebtedness incurred in purchasing and carrying such municipal bonds during the tax year was not deductible as an ordinary and necessary expense in carrying on business although interest paid on such an indebtedness for taxable bonds was made deductible. The pertinent parts of the act above referred to are as follows:

4 "SEC. 214 (a). That in computing net income there shall be allowed as deductions:

"SEC. 214 (a) (2). All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title."

(10) Said section 214 (a) (2) is unconstitutional in that, by its necessary operation, it discriminates against the owners of nontaxable securities and nullifies the immunity from taxation of the

means and instrumentalities of the State and income derived from State or municipal bonds in violation of the due-process clause of the fifth amendment of the Constitution.

(11) The act is also discriminatory and unconstitutional in that in all other kinds of business all such operating expense as interest paid for purchasing and carrying merchandise and inventories are allowed as part of the cost of doing business, whereas the deduction of interest paid by plaintiff and others similarly situated to purchase and carry nontaxable securities, though such interest is in fact an ordinary and necessary operating expense, is prohibited, all of which is contrary to the due process of law and inviolability of private property clauses of the fifth amendment to the Constitution.

(12) The act is also arbitrary, discriminatory, and unconstitutional in that it discriminates against plaintiff and others similarly situated whose resources and capital do not permit them to purchase such tax-free securities for cash and in favor of those whose resources and capital permit them to purchase and carry such securities without borrowing or who have securities other than State or municipal bonds which they can pledge and thereby borrow money to purchase and carry such State and municipal bonds, though in fact the money borrowed and other securities pledged are actually used to carry on the business of buying, carrying, and selling municipal bonds, all of which discrimination is without reasonable reference to any classifiable distinction—in fact or legal effect—between the two methods of conducting the same kind of business and the taxable incomes produced thereby, contrary to and in violation of said provisions of the fifth amendment.

(13) On December 23, 1927, the plaintiff duly filed with the Commissioner of Internal Revenue a claim for the refund of said $40,384.53. Said claim was rejected and refused on January 31, 1928. The Commissioner of Internal Revenue continued to reject and refuse said claim up to the time of filing this petition and said plaintiff is without remedy in the Treasury Department of the United States.

(14) No action has been had on said claim in Congress nor in the department except as aforesaid. No person other than the plaintiff is the owner of said claim or interested therein; no assignment or transfer of this claim or any part thereof or interest therein has been made, and the plaintiff is justly entitled to the amount herein claimed.

(15) The imposition of such additional tax and the collection thereof and the rejection of the plaintiff's claim for refund, as aforesaid, were all without warrant or authority of law, repugnant to the Constitution of the United States in the particulars above stated and in violation of the plaintiff's substantial constitutional rights, as a result of which this plaintiff is now entitled to recover said sum of $40,384.53 with interest thereon at 6% from the time of plaintiff's payment thereof to the defendant on August 4, 1927.

Wherefore, plaintiff prays judgment against the defendant, Charles H. Nauts, collector of internal revenue for the tenth district of Ohio, in the sum of forty thousand three hundred eighty-four and 53/100 dollars ($40,384.53) with interest at six per cent (6%) from August 4, 1927.

MARSHALL, MELHORN, MARLAR & MARTIN,
THOS. O. MARLAR,
Attorneys for Plaintiff.

[*Duly sworn to by W. L. Slayton; jurat omitted in printing.*]

6 *Pracipe*

To the CLERK:

Please issue subpoena against defendant, Charles H. Nauts, as collector of internal revenue for the tenth district of Ohio, addressed to the United States marshal for the northern district of Ohio, returnable according to law, endorsed: "Action for money only, amount $40,384.53 with interest at 6% from August 4, 1927."

THOS. O. MARLAR,
Attorney for Plaintiff.

In United States District Court

Demurrer

Filed Sept. 13, 1928

Now comes the defendant, Charles H. Nauts, collector of internal revenue, by Harry G. Levy, assistant United States attorney, and demurs to the petition of plaintiff heretofore filed herein, for the reason that said petition fails to set forth a cause of action.

CHARLES H. NAUTS,
Collector of Internal Revenue.
By HARRY G. LEVY,
Assistant U. S. Attorney.

7 Overruled with exceptions. We hold that to construe par. 2 of section 2114 (a) of the revenue act of 1921 as applicable in terms or spirit to the fact admitted by the demurrer to exist, to make the enactment unconstitutional, under National Life Insurance Co. vs. U. S., 274 U. S., 734. The statute is competent to sustain a reasonable construction to avoid unconstitutionality. Wherefore we hold that it does not apply to the admitted facts. Judgment for plaintiff on demurrer overruled ordered with the usual certificate of reasonable cause.

JOHN M. KILLITS, *Judge.*

JAN. 4, 1929.

In United States District Court

Order overruling demurrer

Jan. 4, 1929

This day this cause came on to be heard upon the demurrer to the petition of the plaintiff, heretofore filed herein. And the court, upon consideration thereof, overruled said demurrer to which action of the court the defendant, by his counsel, excepts.

In United States District Court

Judgment

Filed Jan. 10, 1929

This cause being heard this day upon the demurrer of the defendant to the petition of the plaintiff and the court being fully advised in the premises, is of the opinion and does therefore order that said demurrer be and the same is hereby overruled, to which ruling of the court the defendant excepts.

8 The court further finds that there was probable cause for the collection by the defendant of the amounts involved in this cause.

It is therefore considered by the court that the plaintiff, W. L. Slayton, have and recover from the defendant, Charles H. Nauts, collector of internal revenue, the sum of $43,837.41, together with costs herein expended.

GEO. P. HAHN,
U. S. District Judge.

Approved
H. G. LEVY,
Assist. U. S. Atty.

In United States District Court

Notice of appeal

Filed Apr. 9, 1929

Please take notice that the above named defendant, Charles H. Nauts, as collector of internal revenue of the United States for the tenth district of Ohio, appeals from the judgment of the District Court of the United States for the Northern District of Ohio, Western Division, in the above entitled case.

Dated, Toledo, Ohio, April 9, 1929.

LEE N. MURLIN,
Assistant United States Attorney,
Attorney for Defendant.

TOLEDO, OHIO, *April 9, 1929.*

Service upon the undersigned as attorney of record of the above plaintiff, W. L. Slayton, in the above entitled cause of the foregoing notice of defendant's appeal from the judgment heretofore rendered in said cause is hereby acknowledged.

THOS. O. MARLAR,
Attorney of Record for Plaintiff, W. L. Slayton.

9 In United States District Court

Petition for Appeal

Filed April 9, 1929

To the Hon. GEORGE P. HAHN,
Judge of the District Court for the
Northern District of Ohio, Western Division.

The above-named defendant, Charles H. Nauts, as collector of internal revenue of the United States for the tenth district of Ohio, feeling aggrieved by the order overruling demurrer of defendant and the judgment rendered and entered in the above-entitled cause on the 10th day of January, 1929, does hereby appeal from said order and judgment to the foregoing circuit court of appeals for the sixth circuit for the reasons set forth in the assignment of errors heretofore filed herein and he prays that his appeal be allowed and that citation be issued as provided by law, and that a transcript of the record, proceedings, and documents upon which such said order and judgment was based, duly authenticated, be sent to the United States Circuit Court of Appeals for the Sixth Circuit under the rules of such court in such case made and provided.

LEE N. MUELLIN,
Assistant United States Attorney,
Attorney for Defendant.

In United States District Court

Assignment of Errors

Filed April 9, 1929

Now comes Charles H. Nauts, as collector of internal revenue of the United States for the tenth district of Ohio, defendant in this cause, and in connection with his appeal, says that in the record, proceedings, findings of fact, conclusion of law, and final judgment of this cause manifest errors intervene to the prejudice of this defendant, to wit:

First. That the court erred in holding that the provisions of paragraph 2 of section 214 (a) of the revenue act of 1921 do not apply to the admitted facts in the cause herein.

10 Second. That the court erred in holding paragraph 2 of section 214 (a) of the revenue act of 1921 unconstitutional when applied to the admitted facts in the cause herein.

Third. That the court erred in overruling the demurrer filed by defendant to plaintiff's petition.

Fourth. That the court erred in rendering judgment for plaintiff against defendant.

Wherefore, this plaintiff prays that the judgment entered herein be reversed.

WILFRED J. MAHON,
United States Attorney.

LEE N. MULLIN,
Assistant U. S. Attorney.

In United States District Court

Order Allowing Appeal

April 9, 1929

On motion of Lee N. Murlin, assistant United States attorney, attorney for Charles H. Nauts, as collector of internal revenue of the United States for the tenth district of Ohio.

It is hereby ordered that an appeal to the circuit court of appeals of the sixth circuit from the judgment heretofore entered herein be and the same is hereby allowed, and that a certified transcript of the record, testimony, exhibits, stipulations, and all proceedings be forthwith transmitted to said circuit court of appeals.

11–12 [Citation in usual form showing service on W. L. Slayton omitted in printing.]

13 In United States District Court

Stipulation re certification of record

Filed Apr. 13, 1929

In accordance with section 7 of rule 44 of the general rules of this court,

It is hereby agreed that the record as presented to the clerk by the printer, may be certified by the clerk as required by law and the rules of the appellate court, as a true, full, and complete copy of the original pleadings, papers, and orders used on the trial of this cause, as set forth in the praecipe for transcript, without further comparison by the clerk.

THOS. O. MARLAR,
Attorney for Plaintiff.
LEE N. MURLIN,
Attorney for Defendant.

In United States District Court

Precipe for transcript of record

Filed May 4, 1929

To the CLERK:

Please prepare transcript of record for the United States Circuit Court of Appeals, Sixth Circuit, in the above-entitled cause, including therein the following papers and orders:

Caption.
Petition.
Demurrer to petition.
Order overruling demurrer.
Order of final judgment for plaintiff.
Petition for appeal.
Order allowing appeal.
Notice of appeal and acknowledgment of service thereof by attorney of record for plaintiff.

14 Assignment of errors.

Citation including acknowledgment of service thereof by attorney of record for plaintiff.
Praecipe for transcript.
Any entries extending time in which to file printed record in court of appeals, if such entries should be filed.
Stipulation re certification of record.
Certification of clerk.

LEE N. MURLIN,
Attorney for Defendant.
CHAS. H. NAUTS,
Collector of Internal Revenue.

In United States District Court

Order extending time for filing transcript of record

May 8, 1929

For good cause shown, it is hereby ordered that the time for filing the record in the circuit court of appeals for the sixth circuit in the above-entitled cause be extended to June 7, 1929.

15 [Clerk's certificate to foregoing transcript omitted in printing.]

16 In United States Circuit Court of Appeals, Sixth Circuit

Cause argued and submitted November 6, 1929, before MOORMAN, HICKS and SIMONS, JJ.

This cause is argued by Ottamar Hanele for appellant and by Thos. O. Marlar for appellee and is submitted to the court.

In United States Circuit Court of Appeals

Judgment

Filed Dec. 6, 1929

Appeal from the District Court of the United States for the Northern District of Ohio.

This cause came on to be heard on the transcript of the record from the District Court of the United States for the Northern District of Ohio, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the judgment of the said district court in this cause be and the same is hereby affirmed.

17 [File endorsement omitted.]

No. 5437

In United States Circuit Court of Appeals, Sixth Circuit

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, appellant, v. W. L. SLAYTON, APPELLEE.	Appeal from the United States District Court, Northern District of Ohio, Western Division.

Decided December 6, 1929

Before MOORMAN and HICKS, Circuit Judges, and SIMONS, District Judge.

Opinion

Filed Dec. 6, 1929

SIMONS, District Judge: This action is to determine the applicability of provisions of the revenue act of 1921, to admitted facts, and their constitutionality as applied. For convenience plaintiff in the court below, and appellee here, will be referred to as the taxpayer; the defendant below as the collector.

During the year 1922 the taxpayer was engaged in the business of buying, selling and dealing in municipal bonds. During that year he received as interest from bonds owned by him $65,720.06. During the same period he paid as interest on money borrowed to buy and carry such bonds the sum of $78,153.84. In his return for the year he excluded from his gross income the interest from the bonds, for the reason that such income was exempt. He deducted interest paid during the year and set it off against profit made upon the sale of bonds. Upon audit of his return, the Treasury Department disallowed the deduction of interest paid and assessed additional taxes based upon a recomputation of his income

after the disallowance of such deduction. These additional taxes were paid. Claim for refund was duly filed and rejected,
18 and the taxpayer sued for the purpose of recovering the paid additional tax. To the taxpayer's petition the defendant demurred. The court overruled the demurrer, and upon failure of the collector to plead entered judgment in favor of the taxpayer and as against the collector for the amount claimed. This appeal is taken by the collector to review the judgment.

The Treasury Department in disallowing the taxpayer's deduction of interest paid, and in assessing an additional tax, assumed to act under the authority of sections 213 and 214, of the revenue act of 1921. Section 213, defining gross income, specifically exempts interest upon obligations of a State, Territory, or any political subdivision thereof. Section 214a provides that in computing net income there shall be allowed as deductions,

"2. All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities, * * * the interest upon which is wholly exempt from taxation under this title."

The taxpayer bases his right to recovery upon two main contentions. First, that he is not an investor in tax-exempt securities, but a dealer; that the section is intended to reach only those who invest in tax exempt securities for the purpose of producing non-taxable income, and that as his primary purpose is to produce taxable income, to wit, the profits made upon the purchase and sale of tax-exempt securities, and that as such primary purpose is set up in his petition and admitted by the demurrer, section 214-a-2 is not applicable to him. Furthermore, that in his case the interest paid ought not to be treated purely as interest, but as one of the [illegible] and necessary expenses of doing business, to be deducted from gross income in order to ascertain his net income. Secondly, that if the statute is applicable to him, it is unconstitutional, as imposing a burden upon the obligations and securities of a State or its political subdivision.

The district judge held that the statute did not apply to admitted facts; that so to apply it would make the enactment unconstitutional, and that it is susceptible to a construction to avoid unconstitutionality. Were there any ambiguity in the language of the section, such rule of statutory construction might be here considered, but we find none. The terms of the section are plain, and being
19 clear the letter of the law must control. We pass over also without detailed consideration the contention that the interest paid must be treated not as pure interest, but as one of the elements in the cost of doing business. Even were we to consider that there are here present the special circumstances under which interest may be treated as among the "ordinary and necessary expenses" suggested by the Supreme Court in *Anderson v. 32 Broadway Company*, 239 U. S. 69, it is clear from the circumstances of this particular

case that the only interest paid that could be so treated would be the excess of interest paid over the amount of interest received. Manifestly this is not the interest here in question, nor upon the disallowance of which this suit is based. The taxpayer herein is seeking to recover all of the additional tax computed upon the disallowance of a deduction of all of the interest paid.

We come then to the disputed constitutionality of the statute. The taxpayer relies upon and the collector challenges the holding of the Supreme Court in National Life Insurance Company v. United States, 277 U. S. 508, as authority for the invalidity of the section herein considered. In that case the court was called upon to deal with section 245–a of the revenue act of 1921. That section provided:

"a. That in case of a life insurance company the term net income means the gross income less—

1. The amount of interest received during the taxable year which under paragraph (4) of subdivision (c) of section 213 is exempt from taxation under this title (interest on tax exempt securities);

2. An amount equal to the excess, if any, over the deductions specified in paragraph (1) of this subdivision of four per centum of the mean of the reserve fund required by law and held at the beginning and end of the taxable year."

The petitioner there maintained that the result of the collector's action in deducting from the four per cent of the mean of the reserve fund an amount equivalent to the company's income from tax exempt securities was unlawfully to discriminate against it and really to exact payment on account of its exempt securities, contrary to the Constitution and laws of the United States, and also that diminution of the ordinary deduction of four per cent of the reserve because of interest received from tax exempt securities in effect defeated the exemption guaranteed to their owners. The court held that one may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted. Also, that the Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others.

The collector here seeks to distinguish the situation with respect to tax exempt securities provided for in section 245 from that in section 214. He contends that the statute involved in the insurance company case gives to all taxpayers exactly the same deduction; that no one is entitled to deduct the interest which he pays to purchase or carry municipal bonds, and on the other hand, that everyone is entitled to deduct all other interest. In our judgment the situation created by the two sections with respect to the taxation of tax exempt securities is the same, and the applicable principle identical. To deprive the taxpayer of the right to deduct from gross income

interest that he has paid during the taxable year because that interest was paid on money borrowed to purchase tax exempt securities is, looking through form to substance, directly to tax the interest of such securities, and so not within the power of Congress to authorize. It is important to note that the Supreme Court in the National Life Insurance case considered the deduction of tax exempt interest from the four per cent allowance a direct and purposeful tax upon a State obligation, and did not rely upon any rule to the effect that what Congress may not do directly it can not do indirectly. This renders unnecessary a consideration of those cases wherein the exercise of the congressional authority to tax more or less remotely affected the sale of State securities, or remotely or incidently impaired the borrowing power of the State. Typical of such cases is Plummer v. Coler, 178 U. S. 115; Florida v. Mellon, 273 U. S. 12. As we shall see presently, the tax in the instant case is even more obviously a direct tax upon the income of State obligations than was the tax in the insurance case.

In the latter it was argued in able dissenting opinions that the four per cent deduction allowed to insurance companies was not given to them as a matter of right; that the allowance of a deduction of four per cent of the mean of the reserve was, as Mr. Justice Brandeis put it, a favor, and as Mr. Justice Stone expressed it, a matter of grace, or a bounty, and in their dissenting opinions (Mr. Justice Holmes concurring with Justice Brandeis), they saw no constitutional reason why in granting a favor or a bounty the Congress could not lawfully take into consideration an exemption already possessed by the holders of tax exempt securities, every insurance company holding such tax exempts being already permitted by the statute to deduct the interest therefrom to the full extent received. In the instant case there is involved no such act of grace on the part of the Congress. There is taken from the taxpayer something which every other taxpayer is allowed, namely the privilege of deducting interest on borrowed money from gross income. It is not a case of making him a gift, and then adjusting the size of the gift to that which he already possesses. To refuse to allow the taxpayer to deduct his interest in effect results in the taxation of something which is not income. We do not here question the power of Congress to make gross income the criterion of a taxpayer's liability, but this it has not done. The settled policy of the Government, in this and other income tax statutes, has been to make net income measure the taxpayer's liability.

In arriving at the conclusion indicated we have not been at all influenced by the holding in Bunn v. Willcuts, collector, 29 Fed. (2nd) 132, a decision of the District Court of the District of Minnesota, to which the taxpayer has specifically called our attention. In that case there was a holding that not only was the interest from municipal securities exempt from Federal taxation, but also that

profit made from the purchase and sale of such securities is likewise exempt. Even were we to consider the question as not foreclosed by the holdings of the Supreme Court in Plummer v. Coler, 178 U. S. 115; Orr v. Gilman, 183 U. S. 278, it is not now before us. Here no question is raised as to the taxability of profits made in the purchase and sale of municipal bonds. Such profit was included in gross income, and the tax paid upon it is not herein sought to be recovered. Indeed the petitioner's argument in support of the contention that the statute does not apply to him is founded upon the claim that the primary purpose of his borrowing was to produce taxable income, and not tax-exempt income.

In view of section 1403, of the act, it is necessary to go no further than did the court in the National Life Insurance case, and so to hold that the disallowance of interest paid and the additional tax assessed against the taxpayer based upon such disallowance cannot be given effect as against the taxpayer under the circumstances here disclosed He was lawfully entitled to the judgment obtained in the court below, and

It is hereby affirmed.

22 In the United States Circuit Court of Appeals

Motion for order staying mandate

Filed Jan. 4, 1930

Now comes the appellant by his counsel, Lehr Fess, assistant United States attorney for the northern district of Ohio, and shows the court that consideration is now being given by the office of the Attorney General of the United States to the question of filing a petition for writ of certiorari in the above case prior to the 6th day of January, 1930, on which day mandate is to be issued by this court, and respectfully moves the court for an order in the above case staying the issuance of the mandate herein for a period of three months from December 6, 1929, in accordance with the practice of the court.

CHARLES H. NAUTS.
Collector of Internal Revenue.
By LEHR FESS.
Assistant U. S. Attorney.

Service of copy of the above application for order staying mandate is hereby acknowledged, together with consent to the allowance of such application.

THOS. O. MARLAR,
MARSHALL, MELHORN, MARLAR & MARTIN,
Attorneys for Appellee.

In United States Circuit Court of Appeals

Order staying mandate

Filed Jan. 6, 1930

Ordered, that motion to stay mandate herein pending application to the Supreme Court for writ of certiorari is hereby granted and the mandate is stayed for sixty days from this date; provided that, if within such sixty days, the applicant shall file with the clerk of this court the certificate of the clerk of the Supreme Court that the certiorari petition, record, and brief have been filed and that proof by affidavit of notice thereof under paragraph 3 of rule 38 of the Supreme Court has been given, the stay shall continue until
23 the final disposition of the case by the Supreme Court. Unless this condition is complied with within such sixty days or any extension thereof made by the court or any judge thereof, or if the condition is complied with, then upon the filing of copy of an order denying the writ applied for, the mandate shall issue.
24 [Clerk's certificate to foregoing transcript omitted in printing.]

25 Supreme Court of the United States

Order allowing certiorari

Filed April 28, 1930

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted. And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Indorsement on cover:] File No. 34850. U. S. Circuit Court of Appeals, Sixth Circuit. Term No. 719. Charles H. Nauts, collector of internal revenue, petitioner, vs. W. L. Slayton. Petition for writ of certiorari and exhibit thereto. Filed March 6, 1930. File No. 34850.

FILE COPY

MAR 6

No. ~~719~~ 60

In the Supreme Court of the United States

OCTOBER TERM, 1929

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

W. L. SLAYTON

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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In the Supreme Court of the United States

OCTOBER TERM, 1929

No. ——

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, petitioner

v.

W. L. SLAYTON

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

PETITION

The Attorney General, on behalf of Charles H. Nauts, Collector of Internal Revenue for the Tenth District of Ohio, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled case on December 6, 1929 (R. 16), affirming the judgment of the United States District Court for the Northern District of Ohio. (R. 7, 8.)

STATEMENT

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income the source of which is not disclosed by the record, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy and carry the municipal bonds the sum of $78,153.84. In making his income-tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds, and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds. (R. 2.)

Upon review and audit of this return the Commissioner of Internal Revenue disallowed this deduction, and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest amounting to $7,778.04, the respondent paid on demand under protest on August 4, 1927. (R. 2, 3.) He then filed a claim for refund which was rejected. (R. 5.)

The respondent thereupon filed his petition in the United States District Court for the Northern District of Ohio to recover said sum (R. 1, 2) and the petitioner demurred thereto. (R. 6.) The District Court overruled the demurrer and, upon fail-

ure of the petitioner to answer, entered judgment for the respondent. (R. 7, 8.) From this judgment, an appeal was prosecuted to the Circuit Court of Appeals for the Sixth Circuit (R. 8–11), which sustained the District Court (R. 16, 19).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress could not constitutionally refuse to permit, in the computation of taxable net income, the deduction of interest paid on indebtedness incurred to purchase and carry tax-exempt bonds, while allowing the deduction of other interest paid.

REASONS FOR GRANTING THE WRIT

The decision of the Circuit Court of Appeals declares unconstitutional the provision of Section 214 (a) (2), of the Revenue Act of 1921, which denies permission to deduct interest paid on indebtedness incurred to buy or carry tax-exempt securities while allowing the deduction of other interest paid. The question of the power of Congress to enact this provision is an important one which has not been but should be passed on by this Court.

The Circuit Court of Appeals decided that to deny the deduction of such interest paid is in effect to tax State obligations. In so deciding that court probably incorrectly applied the decision of this Court in the case of *National Life Insurance Co.* v. *United States*, 277 U. S. 508, which held that Section 245 (a) (2) of the Revenue Act of 1921 was invalid

in so far as it undertook to reduce the 4 per cent deduction of the mean reserve fund of a life insurance company by the amount of interest received from tax exempt securities. It is believed that the present case is not within the scope of that decision, as in this case there is no necessary relation between the income from the bonds and the amount of interest paid on indebtedness incurred to buy or carry them.

The question is far-reaching in its application and importance and affects a large number of taxpayers.

Another phase of the question of the constitutional limits of the taxing power of Congress, as affecting the obligations of States, will come before this Court in *Willcuts* v. *Bunn*, No. 535, October Term, 1929, in which certiorari to the Circuit Court of Appeals for the Eight Circuit was granted on January 27, 1930.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Sixth Circuit should be granted.

WILLIAM D. MITCHELL,
Attorney General.

MARCH, 1930.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 7) is not reported. The opinion of the Circuit Court of Appeals (R. 16) is reported in 36 F. (2d) 145.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth Circuit was entered December 6, 1929. (R. 16.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is it within the constitutional power of Congress to withhold from taxpayers, in the computation of taxable net income, the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest paid?

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

> SEC. 213. That for the purposes of this title * * * the term "gross income"—
>
> * * * * *

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * *

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or of the District of Columbia; * * *

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

* * * * *

STATEMENT

A statement of the facts and the error to be relied upon will be found in the petition.

ARGUMENT

The Act expressly excludes from the definition of gross income interest from obligations or securities of a State or a political subdivision thereof. Section 213 (b) (4), *supra*. The question is whether the refusal of Congress to permit the deduction from gross income, in arriving at the net

income, of interest paid on indebtedness incurred to purchase or carry such obligations, while allowing the deduction of other interest paid, is in substance a tax upon the obligations. The Circuit Court of Appeals held that the result is to tax directly the income from the obligations, and it relied upon the decision of this Court in *National Life Insurance Co.* v. *United States,* 277 U. S. 508. That case is cited also for the proposition that one may not be subjected to greater burdens upon his taxable property because he owns property that is nontaxable. It is submitted that that decision is not applicable to the situation in the instant case, and that the provision here in question does not have the effect apprehended by the Circuit Court of Appeals.

The *National Life Insurance Company case* involved the interpretation of a different section of the 1921 Act, viz., Section 245, which defines net income in the case of life insurance companies. Net income is there defined as gross income less (1) the amount of interest received during the taxable year from tax-exempt securities, and (2) an amount equal to 4 per cent of the company's mean reserve funds, diminished, however, by the amount of the first deduction, *i. e.* the interest from tax-exempt securities.

Thus there was in that case a direct and inevitable relation between the amount of deduction for tax-exempt interest and the amount of deduction otherwise allowed as a percentage of the reserve

fund. Here there is no necessary relation between the nontaxable income and the deductions allowed in determining taxable net income. The exemption from tax of the income from State obligations extends to every citizen, and the taxpayer is not subjected to any greater burden by reason of his ownership of such obligations. The amount of taxable income does not depend upon the ownership of or receipt of interest from tax-free securities. Taxpayers having the same "taxable" income are not treated differently because one owns tax-free securities. The Act gives to all taxpayers the same deductions. No one is entitled to deduct interest paid on indebtedness incurred to purchase or carry municipal bonds, and, on the other hand, everyone is entitled to deduct all other interest.

It is only where the taxpayer incurs indebtedness to buy or carry such securities that the question can arise, and then the amount of interest paid on the indebtedness bears no necessary relation to the amount of nontaxable income.

The limitation does not affect one who owns or receives income from tax-free securities differently from one who does not. It distinguishes between one who borrows money for the purpose of producing nontaxable income and one who borrows for other purposes. The respondent had the benefit and advantage of the exemption of the income. The asserted disadvantage to him arose because he chose to borrow money to buy or carry the tax-free

securities. One who did not incur such indebtedness suffered no disadvantage. The real situation seems to be that respondent claims an additional benefit because he has incurred the indebtedness.

It is submitted that the above facts are sufficient to take the case out of the principles laid down in the *National Life Insurance Company case.*

The limitation of the interest deduction first appeared in Section 1201 of the Revenue Act of 1917, c. 63, 40 Stat. 300, 330. It has appeared in all subsequent Revenue Acts. Its manifest purpose was to exclude from the calculation of taxable income expenses which did not arise from the production of such income. Cf. *United States* v. *Anderson,* 269 U. S. 422, 440; *American National Co.* v. *United States,* 274 U. S. 99, 104. Without this limitation, the borrowing of money for investment in tax-free bonds may be the means of avoiding the tax on income from other sources. One who invests his entire capital of $100,000 in taxable securities pays a tax on the interest he receives from them. Were there no limitation, he could invest in tax-free securities an equal amount of borrowed money and exempt his *entire* income from taxation, assuming that interest rates are equal. The restriction merely denies the deduction from taxable income of expenditures made in producing income that may not be taxed. It is justified by the practical necessity of preventing such borrowings for the purpose of evading the tax on other income. Otherwise, there

would be discrimination against those who do not own tax-free securities. Congress is not under the duty of offering special advantages to the holders of tax-free securities.

A taxpayer has not an inherent right to any deduction. Deductions are a matter of legislative discretion and authority for all deductions must be found in the statute. *New Creek Co.* v. *Lederer*, 295 Fed. 433, 435; *Consolidated Gas, Electric Light & Power Co.* v. *United States*, 65 C. Cls. 252, certiorari denied, 278 U. S. 612.

It is likewise settled that, in determining the taxable income, Congress may limit the amount of interest which may be deducted from gross income. *Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69; *United States* v. *Barwin Realty Co.*, 25 F. (2d) 1003.

Before the Circuit Court of Appeals, respondent also argued that the interest paid to carry municipal bonds by one whose business was buying and selling bonds was an ordinary and necessary expense of the business that must be deducted in computing taxable income. However, this contention was rejected by the Circuit Court of Appeals because the circumstances of the present case do not bring it within the special circumstances under which interest may be treated as "ordinary and necessary expenses" suggested by this Court in *Anderson* v. *Forty-Two Broadway Co.*, *supra*. Manifestly, the Circuit Court of Appeals was cor-

rect in this view, since the deduction of interest is specifically covered by subdivision (a) (2) of Section 214.

Since it has been shown that the taxpayer receives full benefit of exemption from tax of the municipal securities and the income therefrom, the only other point at which the provision in question could infringe the constitutional guaranty is in a restriction of the market for such bonds creating a burden on the borrowing power of the State. But the Constitution does not require the United States to hold out special inducements to invest in State bonds, or to assist the State in disposing of its securities. See *Florida* v. *Mellon*, 273 U. S. 12, 17. Moreover, it is well settled that such a restriction is not of itself unconstitutional. The rule is stated by this Court in *Plummer* v. *Coler*, 178 U. S. 115, 137–138, as follows:

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

Clearly the effect of the limitation in this case on the borrowing power of the municipalities is neither obvious nor appreciable. As this Court

said in *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523:

> In a broad sense, the taxing power of either government, even when exercised in a manner admittedly necessary and proper, unavoidably has some effect upon the other. The burden of federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states, and *vice versa*. Taxation by either the state or the federal government affects in some measure the cost of operation of the other.

The only "disadvantage" that a holder of tax-exempt securities may suffer under this restriction, as against a holder of taxable securities, is in a case like the present where the taxpayer places himself in the situation that he is paying more interest to purchase or carry nontaxable securities than he receives upon them. He will then pay more tax than he would if he held taxable instead of nontaxable bonds. To the extent of the excess of interest paid over that received he is deprived of a deduction given to others. This, however, is not a necessary effect of the statute. It is fortuitous—arising not in every case but only in cases where the taxpayer is unfortunate or ill-advised, or finds advantage in paying more interest on the purchase or carrying of tax-free securities than he receives from them during a certain period. If the taxpayer paid less than he received, he would be better off to that extent. That the statute works an occasional hardship is not sufficient to condemn it. In its general

application, the statute does not place the taxpayer at a disadvantage but at most merely fails to give him an additional advantage.

This Court will shortly have before it the case of *Willcuts, Collector of Internal Revenue* v. *Bunn*, No. 535, which involves a related question, viz. the power of Congress to tax the gain derived by the owner of municipal bonds from the sale of such bonds at a profit. The Circuit Court of Appeals for the Eighth Circuit held the tax on such gain unconstitutional. (35 F. (2d) 29.) This Court granted certiorari on January 27, 1930.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

WILLIAM D. MITCHELL,
Attorney General.

G. A. YOUNGQUIST,
Assistant Attorney General.

SEWALL KEY,
ANDREW D. SHARPE,
Special Assistants to the Attorney General.

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T. H. LEWIS, Jr.,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

MARCH, 1930.

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No. 60

In the Supreme Court of the United States

OCTOBER TERM, 1930

EUGENE DENMAN, ADMINISTRATOR OF THE ESTATE OF CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

W. L. SLAYTON

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 60

EUGENE DENMAN, ADMINISTRATOR OF THE ESTATE of Charles H. Nauts, Collector of Internal Revenue, petitioner

v.

W. L. SLAYTON

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the District Court (R. 4) is not reported. The opinion of the Circuit Court of Appeals (R. 9) is reported in 36 F. (2d) 145.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth Circuit was entered December 6, 1929. (R. 9.) Petition for certiorari was filed on March 6, 1930, and certiorari was granted on April 28, 1930. (R. 14.) The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is it within the constitutional power of Congress to deny taxpayers, in the computation of taxable net income, the right to deduct interest paid on indebtedness incurred to purchase or carry State and municipal bonds, while permitting the deduction of other interest paid?

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 238, 239, provides:

> SEC. 213. That for the purposes of this title * * * the term "gross income"—
>
> * * * * *
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or of the District of Columbia; * * *
>
> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities

> (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; * * *.

STATEMENT

The case was decided in the District Court on demurrer to a petition which set forth the following facts (R. 1-4):

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds, particularly municipal bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income, the source of which is not disclosed by the record, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy, carry, and sell the municipal bonds the sum of $78,152.84. In making his income-tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds. (R. 1.)

Upon review and audit of this return, the Commissioner of Internal Revenue disallowed this deduction and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest, amounting to $7,778.04, the respondent

paid on demand under protest on August 4, 1927. (R. 1, 2.) He then filed a claim for refund and upon its rejection (R. 3) brought suit against the Collector in the United States District Court for the Northern District of Ohio to recover the sum so paid (R. 1). The Collector's demurrer was overruled and judgment was entered for the respondent. (R. 5.) The Circuit Court of Appeals affirmed the judgment. (R. 9–13.)

The trial court took the view that the statute would be unconstitutional if applied to the admitted facts, and held that it had no application. The Circuit Court of Appeals held that the statute does apply and that under the authority of *National Life Insurance Company* v. *United States*, 277 U. S. 508, it is unconstitutional in that it seeks to impose a direct tax upon income from State obligations.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress could not constitutionally refuse to permit, in computation of taxable net income, the deduction of interest paid on indebtedness incurred to purchase and carry tax-exempt bonds, while allowing the deduction of other interest paid.

SUMMARY OF ARGUMENT

1. The statute applies to a dealer in municipal bonds as well as to a private investor. The court below so held.

A deduction for interest paid can not be taken as a business expense under Section 214 (a) (1) of the Revenue Act of 1921. In the Revenue Acts the two classes of deduction have always been distinguished and have been separately provided for. The very provision as to the exception here involved shows an intent to allow them as distinct items of deduction.

2. The statute does not operate to impose a direct tax on income from municipal bonds or to impose an appreciable burden upon the borrowing power of the State. The case differs from *National Life Insurance Company* v. *United States,* 277 U. S. 508, *supra,* in that there the exclusion from income of tax-free interest was exactly offset by a corresponding diminution of another item of deduction, while here there is no exact relation or even necessary relation between the exclusion of tax-free interest from income and the denial of a deduction of interest paid to buy or carry tax-free bonds. The limitation does not affect one who receives tax-free interest differently from one who does not.

The limitation is not a burden upon the borrowing power of the States, for it has no relation to the exercise of that power, and has not in fact affected it.

3. The classification is just and reasonable. Taxpayers have no inherent right to deductions. Congress may classify incomes for purposes of taxation and may limit deductions of interest. Other similar classifications have been made.

If any portion of the interest paid was chargeable to purposes other than buying and carrying tax-free bonds, the amount of it does not appear. In any event, taxing statutes can not be applied with mathematical exactness. That the statute may work an occasional hardship does not condemn it.

Every presumption is in favor of the constitutionality of the Act.

ARGUMENT

I

THE EXCEPTION IN SECTION 214 (a) (2) MAY NOT BE DISREGARDED, EITHER ON THE THEORY THAT IT DOES NOT INCLUDE INTEREST PAID BY DEALERS OR ON THE THEORY THAT SUCH INTEREST IS DEDUCTIBLE AS A BUSINESS EXPENSE

Section 213 (b) (4) of the Revenue Act of 1921 (p. 2, *supra*), excludes from gross income the interest derived from obligations of a State or a political subdivision thereof. Section 214 (a) (2) of the same Act allows as a deduction, in computing net income, all interest except that paid on indebtedness incurred or continued to purchase or carry securities the interest from which is wholly exempt from tax.

The court below held that the statute is unambiguous and that it plainly applies to all interest paid to purchase or carry tax-free securities, whether by a private investor or by a dealer. The point hardly requires argument. If the taxpayer should contend that the statute has no application here because of the allegation in the petition in

the District Court that money was borrowed and interest paid thereon for the purpose, *inter alia,* of "selling" tax-free securities, two answers occur: (1) No interest obligation can possibly be incurred in selling bonds, and (2) if it was, it would seem the burden was on taxpayer to plead how much of the interest payments here involved are chargeable to that activity.

The further contention was made by the taxpayer in the court below and is made in the brief of *amici curiae* here, that since the interest was paid by the taxpayer in connection with his business as a dealer in securities it does not fall within the provisions of Section 214 (a) (2) of the Revenue Act of 1921, but is deductible as an ordinary and necessary expense in carrying on the business under the provisions of Section 214 (a) (1) of the same Act.

The deduction of interest payments has always been provided for separately from the deduction of business expenses. Act of October 3, 1913, c. 16, 38 Stat. 114, 166, Sec. II, B; Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 5 (a) Second, as amended by Revenue Act of 1917, c. 63, 40 Stat. 300, 330, Sec. 1201 (1); Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066, Sec. 214 (a) (2); Revenue Act of 1921, c. 136, 42 Stat. 227, 239, Sec. 214 (a) (2). In the Regulations, deductions of interest are dealt with separately from deductions for business expenses. Regulations 62 (1922 ed.), Articles 101, 121. The

very provision as to the exception here involved shows an intent to allow them as distinct items of deduction. The separation of the two classes of deductions is as distinct here as it was in the Corporation Tax Act of August 5, 1909 (36 Stat. 11, 112, c. 6, Sec. 38), construed by this Court in *Anderson* v. *Forty-two Broadway Company*, 239 U. S. 69.

II

THE ACT IS NOT UNCONSTITUTIONAL AS TAXING A STATE INSTRUMENTALITY

Because of the implied prohibition in the Constitution against interference by the Federal Government with the functioning of the governments of the States, a tax is invalid if it is a direct tax upon an instrumentality of a State or if it imposes a burden upon its borrowing power. We submit that the refusal of Congress to permit the deduction of the interest payment here in question does not so operate.

The court below held that the refusal to allow the deduction constituted a direct tax on the income from municipal securities, and relied on the case of *National Life Insurance Company* v. *United States*, 277 U. S. 508, *supra*. That case involved the constitutionality of Section 245 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 261, which defines net income of life-insurance companies, for income tax purposes, as the gross income less certain deductions, among them being (1) the amount of interest received during the taxable year from tax-exempt

securities, and (2) an amount equal to four per cent. of the company's mean reserve funds, provided that the amount of this deduction be diminished by the amount of the first deduction, i. e., the interest from tax-exempt securities. The result was that the deduction of the exempt interest from gross income was exactly offset by the elimination of an equal amount from the deduction otherwise allowed by the statute. In practice, therefore, an insurance company holding tax-exempt securities was required to pay exactly the same amount of income tax that it would have paid had the securities been taxable instead of exempt, and this Court held that the statute in effect imposed a direct tax upon income from the exempt securities and was therefore invalid.

Here the situation is different. The statute has neither direct effect nor remote effect upon the owner of exempt securities who does not borrow to buy or carry them. When an owner of such securities does borrow, the statute does not affect the exemption to which he is entitled, but it does affect the amount of his allowable deduction in a manner having neither exact nor necessary relation to the amount of his income from exempt sources. The amounts borrowed to buy or carry the exempt securities may be but a small percentage of the actual cost of the securities. The interest rates for the borrowed money are probably greater, in most instances, than the interest rates of the exempt securities, but the total interest received may exceed

greatly the total interest paid, this depending largely upon the relation of the total amount borrowed to the total purchase price. Thus it is clear that in refusing to allow deductions for interest paid to buy or carry exempt securities Congress has made no effort to offset, even approximately, the interest received from such securities, and there is no indication of the intention to produce, nor is there produced, a result which amounts to a tax, direct or indirect, on the exempt income.

Nor is the case of *Missouri* v. *Gehner*, 281 U. S. 313, controlling here. The operation of the State taxing statute there involved was, as held by the Court, directly and necessarily to include in the value of the property taxed a definite proportion of the United States bonds owned by the taxpayer. There, ownership of such bonds inevitably resulted in the inclusion of a portion of their value, whereas here neither the ownership of the bonds nor the receipt of income from them results in an increased tax, and the taxpayer is affected at all only if he has borrowed capital for their purchase.

The limitation under consideration appeared first in Section 1201 of the Revenue Act of 1917, c. 63, 40 Stat. 300, 330, and it has appeared in all subsequent Revenue Acts. The intent which prompted its enactment is reflected in the report of the Senate Finance Committee relating to Section 214 (a) (2) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1060), which is substantially the same

as Section 214 (a) (2) of the 1921 Act, *supra*. The report (Senate Report No. 617, 65th Congress, Third Session, p. 6) said:

> The interest deduction (sec. 214a, 2, and sec. 234a, 2) has been amended so as not to permit a deduction for interest on indebtedness incurred or continued to purchase or carry tax-free securities other than obligations of the United States issued after September 24, 1917. This limitation is substantially the same as the one contained in the present law. The provision of the House Bill which allows a deduction for interest on all indebtedness permits the taxpayer to make loans for purchases of wholly exempt securities and then deduct the interest paid on such loans from his otherwise taxable income, thereby reducing his tax. The limitation suggested above would operate to discourage this practice except in the case of the later issue of liberty bonds.

In the *National Life Insurance Co.* case, the effect of the statute was to increase the normal taxable basis (net income) so that the total was the same as if the exempt income were itself taxed. In the present case, on the other hand, the statute merely refuses to permit the further reduction of the normal taxable basis by payments made to buy or carry exempt securities. The basis is left as it would have been had no money been borrowed for such carrying purposes, even though exempt securities were purchased and held and income was

derived therefrom. While in the *National Life Insurance Co.* case, therefore, the inevitable effect of holding exempt securities was to increase the burden upon taxable property, the section involved in the instant case merely leaves the taxpayer to carry his self-imposed burden of borrowing charges without receiving a deduction allowance therefor. His income from exempt securities is untouched, no matter how much it may exceed (or be exceeded by) his borrowing and carrying charges, and in computing his income he receives the same deductions and pays the same tax as anyone else. What respondent claims is an additional benefit because he incurred indebtedness for tax-free securities; but Congress is under no duty to offer special advantages to the holders of exempt securities. Cf. *Florida* v. *Mellon*, 273 U. S. 12, 17.

Nor can it reasonably be contended that the statute imposes a direct or appreciable burden upon the borrowing power of the State. It must first appear that the operation of the statute has some necessary relation to the exercise of that power. No such relation appears here. The borrowing of money is not a necessary concomitant of the purchase and ownership of municipal bonds.

Experience does not indicate that the disallowance of the deduction of interest paid to purchase or carry tax-exempt securities, which began with the Revenue Act of 1917, *supra*, has caused any

substantial impairment of the borrowing power of the States and their municipalities.[1]

As said by this Court in *Plummer* v. *Coler*, 178 U. S. 115, 137–138:

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

The Court also said (p. 136):

> * * * the mischief to our national credit, so feelingly deplored in the briefs, caused by state taxation upon estates of decedents, would be inappreciable, and too remote and uncertain to justify us now in condemning the tax system of the State of New York.

See also *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523; *Heiner* v. *Colonial Trust Company*, 275 U. S. 232, 235.

III

THE CLASSIFICATION IS REASONABLE AND JUST

The general purpose of the allowance of deductions in computing net income is to reduce the tax-

[1] The Report of the Secretary of the Treasury for the year ended June 30, 1929, page 533, Table 61, shows a constant increase of estimated net outstanding indebtedness of States and their municipalities from $[illegible]07,000,000 on June 30, 1917, to $13,404,000,000 on June 30, 1929.

able income by the amount of expenditures made in its production. But taxpayers have no inherent right to deductions and the allowance of deductions is a matter of legislative discretion. *New Creek Co.* v. *Lederer* (C. C. A. 3rd), 295 Fed. 433, 435, certiorari denied, 265 U. S. 581; *Consolidated Gas, Electric Light & Power Co.* v. *United States*, 65 C. Cls. 252, 259, certiorari denied, 278 U. S. 612. Likewise, Congress may limit the amount of interest which may be deducted from gross income. See *Anderson* v. *Forty-two Broadway Co.*, 239 U. S. 69, *supra*, where this Court, considering the Corporation Tax Act of 1909, held that Congress has power to adopt a basis of distinction between corporations carrying an indebtedness that exceeds the amount of the capital and those that do not, and that the provision of the Corporation Tax Act limiting the amount of interest deductions to that paid on so much of the indebtedness as did not exceed the capital stock was not an arbitrary classification.

In *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, this Court held that there is no constitutional objection to distinctions in classifying income for tax purposes where the distinction has a reasonable basis. In considering the question, it was said (p. 25):

> Besides this demonstration of the want of merit in the contention based upon the progressive feature of the tax, the error in the others is equally well established either by prior decisions or by the adequate basis for

> classification which are apparent on the face of the assailed provisions, that is, the distinction between individuals and corporations, the difference between various kinds of corporations, etc., etc. *Knowlton* v. *Moore, supra; Flint* v. *Stone Tracy Co., supra; Billings* v. *United States, supra; National Bank* v. *Commonwealth,* 9 Wall. 353; *National Safe Deposit Co.* v. *Illinois,* 232 U. S. 58, 70. In fact, comprehensively surveying all the contentions relied upon, aside from the erroneous construction of the Amendment which we have previously disposed of, we can not escape the conclusion that they all rest upon the mistaken theory that although there be differences between the subjects taxed, to differently tax them transcends the limit of taxation and amounts to a want of due process, and that where a tax levied is believed by one who resists its enforcement to be wanting in wisdom and to operate injustice, from that fact in the nature of things there arises a want of due process of law and a resulting authority in the judiciary to exceed its powers and correct what is assumed to be mistaken or unwise exertions by the legislative authority of its lawful powers, even although there be no semblance of warrant in the Constitution for so doing.

Instances of somewhat similar classifications in the Revenue Acts are those based upon the amount of taxpayer's invested capital (Section 201 of the Revenue Act of 1917; Sections 301 and 311 of the

Revenue Act of 1918, *supra*; Sections 301 and 312 of the Revenue Act of 1921, *supra*), and also those based upon the distinction between income earned by capital and income earned by labor (Section 209 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 263; Section 209 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 20, U. S. C. App., Title 26, Sec. 940; and Section 31 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 804, U. S. C., Supp. III, Title 26, Sec. 2031).

The taxpayer argued in the court below that the interest expenditure here involved should be allowed because the primary purpose of his borrowing was to produce taxable and not tax-exempt income. The record shows only that his net income (excluding interest received from, and interest paid to carry, tax-free municipal securities) was $28,551.94. It shows also that the entire amount of interest so paid by him was paid to purchase or carry municipal, county, and State bonds. If any part thereof was properly chargeable to other purposes the amount of it does not appear. In any event, taxing statutes can not be applied with mathematical exactness. The circumstance that here the taxpayer paid more interest than he received is entirely fortuitous. That the statute may work an occasional hardship in its reasonable application is not sufficient to condemn it. In its general application the statute does not place the taxpayer at a disadvantage, but merely fails to give him an additional advantage.

Every presumption is in favor of the constitutionality of an Act of Congress. *Nicol* v. *Ames*, 173 U. S. 509; *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *St. Louis S. W. Ry.* v. *Arkansas*, 235 U. S. 350, 369. We submit that the taxpayer has failed to show the unconstitutionality of the statute here involved.

CONCLUSION

It is respectfully submitted that the decision of the Circuit Court of Appeals should be reversed.

THOMAS D. THACHER,
Solicitor General.
G. A. YOUNGQUIST,
Assistant Attorney General.
CLAUDE R. BRANCH,
J. LOUIS MONARCH,
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Special Assistants to the Attorney General.
C. M. CHAREST,
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Bureau of Internal Revenue,
T. H. LEWIS, Jr.,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

JANUARY, 1931.

U. S. GOVERNMENT PRINTING OFFICE: 1931

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CHARLES

IN THE

Supreme Court of the United States

October Term, 1929

No. 60

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE,

Petitioner,

vs.

W. L. SLAYTON,

Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit

BRIEF FOR RESPONDENT IN OPPOSITION

E. J. MARSHALL, *Toledo, Ohio,*
THOS. O. MARLAR, *Toledo, Ohio,*
Attorneys for Respondent

IN THE

Supreme Court of the United States

October Term, 1929

No. 719

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE,

Petitioner,

vs.

W. L. SLAYTON,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION

JURISDICTION

The decree of the Circuit Court of Appeals affirming the decision of the District Court for the Northern District of Ohio, Western Division, was entered on December 6, 1929 (R. 8-11). Petition for writ of *certiorari* was filed March 6, 1930.

QUESTION PRESENTED

The petition for writ of *certiorari* and brief in support presents only one question (page 5 of Brief of Petitioner), namely:

> "Is it within the constitutional power of Congress to withhold from taxpayers in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest paid."

STATEMENT OF FACTS

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy and carry the municipal bonds the sum of $78,153.84. In making his income tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds, and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds (R. 2).

Upon review and audit of this return the Commissioner of Internal Revenue disallowed this deduction, and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest amounting to $7,778.04, the respondent paid on demand under protest on August 4, 1927 (R. 2, 3.) He then filed a claim for refund which was rejected (R. 5).

The respondent thereupon filed his petition in the United States District Court for the Northern District of Ohio to recover said sum (R. 1, 2), and the petitioner demurred thereto (R. 6). The District Court overruled the demurrer, and, upon failure of the petitioner to answer, entered judgment for the respondent (R. 7, 8). From this judgment an appeal was prosecuted to the Circuit Court of Appeals for the Sixth Circuit (R. 8-11), which sustained the District Court (R. 16, 19).

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

> Sec. 213. That for the purposes of this title * * * the term 'gross income'— * * *.
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (4) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or of the District of Columbia; * * *.
>
> Sec. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;
>
> * * * * *

ARGUMENT

It is submitted that this case is controlled by the case of *National Life Insurance Company vs. United States*, 277 U. S. 508. In the *National Life Insurance Company* case this court declared unconstitutional Section 245 (a) (2) insofar as it undertook to reduce the four per cent deduction of the mean reserve fund of a life insurance company by the amount of interest received from tax exempt securities. Section 245 (a) (2) related solely to life insurance companies. Section 214 (a) (2), the section now involved, relates to individuals and is a very similar provision enacted for the same purpose as Section 245 (a) (2).

The petitioner states the sole question involved (page 5, Brief) as follows:

> "Is it within the constitutional power of Congress to withhold from taxpayers, in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest?"

Such question is clearly answered by the *National Life Insurance Company* case, *supra*, for in the opinion, page 594, it is clearly stated:

> "Congress had no power to purposely and directly tax state obligations by refusing to their owners deductions allowed to others."

Section 214 (a) (2) clearly denies to owners of state or municipal securities deductions allowed to others. Under Section 214 (a) (2) all owners of industrial bonds were entitled to interest deductions for interest paid for

the purpose of purchasing and carrying the industrial bonds, while owners of state, county, municipal or other non-taxable securities were not allowed a deduction for interest paid to purchase and carry these securities.

The actual figures in this case show that it was a distinct disadvantage under the proposed operation of Section 214 (a) (2) for the respondent to carry non-taxable securities.

This disadvantage and discrimination is shown as follows:

(1) If the respondent had received taxable interest, the net income would be computed:		
Gross income — interest from bonds	$ 65,720.06	
Profit from operation of business	106,704.78	
		$172,424.84
Less interest paid to purchase and carry taxable bonds		78,153.84
Net income		$ 94,271.00
(2) By reason of the disallowance of the item of $78,153.84 paid out as interest to purchase and carry non-taxable bonds, the government computed taxable income as follows:		
Gross income from all sources		$172,424.84
Less non-taxable interest $65,720.06. Deduction for interest paid to purchase and carry non-taxable bonds ($78,153.84) not allowed.		
Total deductions		65,720.06
For net income		106,704.78

The respondent suffered an actual loss of interest as follows:	
Interest paid out to purchase and carry non-taxable bonds	78,153.84
Non-taxable interest received	65,720.06
Loss on interest	$ 12,432.78

The government not only denies to respondent his constitutional rights respecting non-taxable bonds, but for tax purposes it treats an actual loss as a gain. By the operation of Section 214 (a) (2) the respondent has not only been denied his constitutional rights respecting his non-taxable securities, but has been subjected to greater tax burdens by reason of such ownership.

The foregoing falls directly within the rule as stated in the *National Life Insurance Company* case, page 593:

> "Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted."

The Circuit Court of Appeals, after considering Section 245 (a) (2) and Section 214 (a) (2) in connection with the *National Life Insurance Company* case, stated (R. 18):

> "In our judgment the situation created by the two sections with respect to the taxation of tax exempt securities is the same, and the applicable principle identical. To deprive the taxpayer of the right to deduct from gross income interest that he has paid during the taxable year, because

that interest was paid on money borrowed to purchase tax exempt securities is, looking through form to substance, directly to tax the interest of such securities, and so not within the power of Congress to authorize."

CONCLUSION

Because of our firm conviction that the controlling principle in the instant case is identical to the principle of *National Life Insurance Company* case, we respectfully submit that the petition for a writ of *certiorari* should be denied.

E. J. Marshall,
Thos. O. Marlar,
Attorneys for Respondent.

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Jackson and Erie, Toledo, Ohio

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CHARLES

IN THE

Supreme Court of the United States

October Term, 1930

No. 60

U. G. DENMAN, ADMINISTRATOR OF ESTATE OF CHARLES H. NAUTS, FORMER COLLECTOR OF INTERNAL REVENUE,

Petitioner,

vs.

W. L. SLAYTON,

Respondent.

BRIEF FOR RESPONDENT

E. J. MARSHALL, *Toledo, Ohio,*
THOS. O. MARLAR, *Toledo, Ohio,*
Attorneys for Respondent

IN THE

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W. L. SLAYTON,

Respondent.

BRIEF FOR RESPONDENT

E. J. MARSHALL, *Toledo, Ohio,*
THOS. O. MARLAR, *Toledo, Ohio,*
Attorneys for Respondent

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W. L. SLAYTON,

Respondent.

BRIEF FOR RESPONDENT

JURISDICTION

The decree of the Circuit Court of Appeals affirming the decision of the District Court for the Northern District of Ohio, Western Division, was entered on De-

cember 6, 1929 (R. 9), 36 Fed. (2d) 145. Petition for writ of *certiorari* was filed March 6, 1930, and granted April 28, 1930 (R. 14).

QUESTION PRESENTED

The brief for the petitioner presents only one question:

> "Is it within the constitutional power of Congress to withhold from taxpayers in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest paid?"

STATEMENT OF FACTS

During the year 1922 the respondent was engaged in the business of buying, selling and dealing in bonds. In that year he received $65,720.06 as interest on municipal bonds owned by him. In addition he received other income, which, less all deductions allowed by the statute, amounted to $106,704.78. In his income tax return for the year 1922 he returned all his income excepting only $65,720.06 which he had received as interest on municipal bonds. He deducted from the gross income so returned all the deductions permitted by statute, and, in addition thereto, the $78,153.84 paid out by him as interest to buy and carry municipal bonds (R. 1).

Upon review and audit of this return the Commissioner of Internal Revenue disallowed the deduction of $78,153.84, the interest paid to buy and carry municipal bonds and assessed an additional tax for 1922 of $32,-

606.49. This additional tax, together with interest thereon amounting to $7,778.04, was paid by respondent on demand under protest on August 4, 1927 (R. 2). He then filed a claim for refund which was rejected (R. 3).

The respondent thereupon filed his petition in the United States District Court for the Northern District of Ohio to recover said sum (R. 1, 2), and the petitioner demurred thereto (R. 4). The District Court overruled the demurrer, and, upon failure of the petitioner to answer, entered judgment for the respondent (R. 5). From this judgment an appeal was prosecuted to the Circuit Court of Appeals for the Sixth Circuit (R. 6, 7), which sustained the District Court (R. 9).

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

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>
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ARGUMENT

It is submitted that this case is controlled by the case of *National Life Insurance Company vs. United States*, 277 U. S. 508. In the *National Life Insurance Company* case this court declared unconstitutional Section 245 (a) (2) insofar as it undertook to reduce the four per cent deduction of the mean reserve fund of a life insurance company by the amount of interest received from tax exempt securities. Section 245 (a) (2) related solely to life insurance companies. Section 214 (a) (2), the section now involved, relates to individuals and is a very similar provision enacted for the same purpose as Section 245 (a) (2).

The petitioner states the sole question involved as follows:

> "Is it within the constitutional power of Congress to withhold from taxpayers, in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest?"

Such question is clearly answered by the *National Life Insurance Company* case, *supra*, for in the opinion, page 594, it is stated:

> "Congress had no power to purposely and directly tax state obligations by refusing to their owners deductions allowed to others."

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The actual figures in this case show that it was a distinct disadvantage under the proposed operation of Section 214 (a) (2) for the respondent to carry non-taxable securities.

This disadvantage and discrimination is shown as follows:

(1) If the respondent had received taxable interest, the net income would be computed:		
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Less non taxable interest $65,720.05. Deduction for interest paid to purchase and carry non taxable bonds ($78,153.84) not allowed.		
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The respondent suffered an actual loss of interest as follows:		
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Loss on interest	$ 12,432.78	

The government not only denies to respondent his constitutional rights respecting non taxable bonds, but for tax purposes it treats an actual loss as a gain. By the operation of Section 214 (a) (2) the respondent has not only been denied his constitutional rights respecting his non taxable securities, but has been subjected to greater tax burdens by reason of such ownership.

The foregoing falls directly within the rule as stated in the *National Life Insurance Company* case, page 593:

> "Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted."

The Circuit Court of Appeals, after considering Section 245 (a) (2) and Section 214 (a) (2) in connection

with the *National Life Insurance Company* case, stated (R. 11):

> "In our judgment the situation created by the two sections with respect to the taxation of tax exempt securities is the same, and the applicable principle identical. To deprive the taxpayer of the right to deduct from gross income interest that he has paid during the taxable year, because that interest was paid on money borrowed to purchase tax exempt securities is, looking through form to substance, directly to tax the interest of such securities, and so not within the power of Congress to authorize."

The principles announced in the *National Life Insurance Company* case, *supra*, were affirmed and applied in *Missouri ex rel. Missouri Insurance Company vs. Gehner, Assessor of the City of St. Louis, et al.*, 281 U. S. 313, decided April 14, 1930, where the court held (p. 320):

> "Property taxable by a state may not be taxed more heavily because the owner owns also tax exempt bonds of the United States."

The Chief Justice (p. 322) concurred on the ground that this case was governed by *National Life Insurance Company vs. United States, supra.*

Although the General Counsel, Bureau of Internal Revenue, has refused to apply the above principles and rulings in the present case, he has done so in others as shown by General Counsel's Memorandum, 7668 IX, C. B. 221, where it is held:

> "A disallowance of a portion of the expenses would result in the taxpayer paying more taxes solely due to the existence of some tax exempt income, and, as stated in *National Life Insurance*

> *Company*, a taxpayer 'may not be subjected to greater burdens on his taxable property solely because he owns some that is free'."

It should be noted that municipalities can only market their bonds through dealers. The court will take notice of the general practice. If capital to buy and carry municipal bonds may not be freely borrowed for the purpose on terms and tax burdens no greater than are imposed on borrowing for other purposes, if a special burden or disadvantage is to be imposed on borrowing to buy and carry municipal bonds, the statute clearly and unconstitutionally taxes and burdens municipalities. The effect of the statute is not only to discriminate against and burden municipal bonds in the hands of dealers like respondent, but to burden the municipalities themselves and put them to a disadvantage in marketing their obligations.

CONCLUSION

Because the principle of *National Life Insurance Company* case must control this case, we respectfully submit that the decision of the Circuit Court of Appeals should be affirmed.

Respectfully,

E. J. MARSHALL,
THOS. O. MARLAR,
Attorneys for Respondent.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1930

No. 60

O. G. DENMAN, Administrator of the Estate of CHARLES H. NAUTS, deceased, former Collector of Internal Revenue, *Petitioner*,

v.

W. L. SLAYTON, *Respondent.*

MOTION FOR LEAVE TO FILE JOINT BRIEF AS AMICI CURIAE AND BRIEF

FRED H. DAVIS,
Attorney General of the State of Florida.
ROBERT R. REED,
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49 Wall Street,
New York, N. Y.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1930

No. 60

O. G. DENMAN, Administrator of the Estate of CHARLES H. NAUTS, deceased, former Collector of Internal Revenue, *Petitioner*,

v.

W. L. SLAYTON, *Respondent*.

MOTION FOR LEAVE TO FILE JOINT BRIEF AS AMICI CURIAE

May it Please the Court:

The undersigned, Fred H. Davis, Attorney General of the State of Florida and Robert R. Reed, as Counsel for George B. Gibbons & Co., Inc., respectfully move this Honorable Court for leave to file the accompanying brief in this case as amici curiae.

FRED H. DAVIS,
Attorney General, State of Florida,
on behalf of State of Florida.
ROBERT R. REED,
Counsel for George B.
Gibbons and Co., Inc.,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1930

No. 60

O. G. DENMAN, Administrator of the Estate of CHARLES H. NAUTS, deceased, former Collector of Internal Revenue, *Petitioner*,

v.

W. L. SLAYTON, *Respondent*.

BRIEF OF AMICI CURIAE

STATEMENT.

This brief is offered by present counsel, amici curiae.

1. The State of Florida has an immediate interest in the question at issue in this case, more pressing perhaps than that of many other states. There are many situations in the state where much needed financing has become difficult and in a few instances impossible. Every added burden hurts such financing and renders less saleable or unsaleable the bonds of

one or another city, county, school, road or drainage district. The State itself through a special agency is contemplating the issuance of $2,000,000.00 bonds for flood control in the Everglades, and such issue is necessary to enable the State to secure Federal aid in such work under Rivers and Harbors Act of Congress 1930. In Florida, as in other states, financing is not only necessary for many pressing improvements but it is immediately desirable to relieve unemployment caused by the present depression.

The question at issue is the validity of a tax (in form of income tax) sought to be imposed on dealers in state and municipal obligations, which tax is measured by the interest paid by dealers in carrying such obligations. The states and municipalities are materially affected by this discriminative tax burden. The instrumentalities of the states and their taxpayers bear the burden or receive the benefit, as the case may be, of any tax or tax exemption so directly affecting the marketing of their bonds.

The so-called dealers in municipal securities constitute the original distributing market for all state and municipal bonds. This business is competitive. The great majority of bonds are sold on competitive bidding by dealers located in all the larger cities of the country. The bonds so purchased are normally purchased and carried on moneys borrowed at the banks pending their distribution to investors. The cost of carrying them is affected by the money markets and particularly by the varying interest rates paid in carrying securities. This expense of carrying bonds is a large factor in determining the profit or loss of dealers in municipal markets and anything in the nature of a tax upon this interest

naturally increases the cost and burdens the distribution of the bonds and encourages or discourages dealers in engaging in such business and also in bidding on particular bonds in particular markets. It discourages competition and is a burden upon the states and municipalities by diminishing the price received upon their bonds.

When interest rates are high, as in 1928 and 1929, many dealers, because of such rates and also because of the adverse factor of tax upon the interest paid, withdraw from the municipal market and engage in the distribution of other securities, including corporate stocks, dividends upon which when received by dealers, pending distribution, are partially—and in the case of corporate dealers wholly—exempt from taxation, although the interest paid in carrying such securities is deductible from the gross income of the dealers.

Because of this very direct and discriminative burden and its necessary effect in times of stress in the marketing of state and municipal bonds, present counsel have asked leave to file this brief.

The states as well as the federal government have a governmental interest in the far-reaching constitutional question raised by the petition and in the lower court opinion. Both parties to this appeal are asking the Court to decide this question, but we do not believe that this question need be decided in this case. We submit that the Revenue Act of 1921 properly construed did not impose the tax in question. Section 214 (a) of the Revenue Act of 1921, provided the following deductions:

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

> (2) All the interest paid or accrued within the taxable year on indebtedness, *except on indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title.*"

and others not now in question.

The petition in this case and the opinions below are directed to an attack upon the constitutionality of the exception in paragraph (2), which we have italicized.

We wish to submit to the Court that the interest sought to be deducted in this case was an ordinary and necessary expense of petitioner's business, as appears from the petition, and was therefore properly deductible under paragraph (1).

2. George B. Gibbons & Company, Inc., is a dealer in municipal securities, and the petitioner in a suit now pending in the Court of Claims, to recover taxes paid for the years 1926, 1927 and 1928, presenting substantially the same questions, except as indicated, as the questions here at issue. We present herewith printed copies of the petition in the Gibbons case from which it will appear that the petitioner in that case claims to have deducted interest paid under the paragraph covering the deduction of business expenses, and not under the paragraph permitting the deduction of interest paid outside of any business.

Present counsel are joining in this brief to avoid duplication and expense and to emphasize to the Court the identity of interest between the states and the municipalities issuing securities and the dealers who handle their securities in opposing what we believe to be a discriminative burden sought to be im-

posed by the Federal government upon the normal marketing of such securities.

POINT I.

A FEDERAL TAX OR BURDEN DISCRIMINATIVE IN ITS EFFECT UPON THE MARKETING OF STATE AND MUNICIPAL OBLIGATIONS IS UNCONSTITUTIONAL.

1. The respondent's petition attacks the validity of the prohibition in paragraph (2) of Section 214 (a) of the Revenue Act of 1921 against the deduction of interest paid on indebtedness incurred to purchase state and municipal bonds. While we do not believe this prohibition applies to the petitioner (Point II), the question has been considered and decided by the Court below and is presented on this appeal.

The question is too serious in its implications to be ignored by counsel representing the states.

If this and similar provisions in the several revenue acts specifically discriminating against state and municipal bonds are upheld, a most anomalous result will have been achieved. *The discriminatory tax will be valid. The non-discriminatory tax invalid.* A tax on net income is unconstitutional under the decision if and in so far as interest from muncipal bonds is included in arriving at the net income, although by analogy with the excise tax decisions it is clear that the tax, not being on gross income, is not on the interest received as such and is in no way a specific tax on such interest, while on the other hand a specific provision adding to the net income as otherwise determined the amount not of interest received or other income, but of an essential and very heavy expense

incurred in carrying municipal bonds, though in terms and effect a direct and special burden on the marketing, purchasing or carrying of such bonds, is, it is now claimed, constitutional.

In principle and of necessity it seems to us that this question, when presented, can only be decided against the government.

> *National Life Insurance Co. v. U. S.*, 277 U. S. 508 and cases cited.
> *Macallen Co. v. Massachusetts*, 279 U. S. 620.
> *U. S. Glue Co. v. Oak Creek*, 247 U. S. 321-329, and
> *Peck v. Lowe*, 247 U. S., 165 at page 174.

In the last named case, referring to the income tax as affecting an exporter, the Court said, "It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the Act are: 'net income arising or accruing from all sources.' *There is no discrimination.*" (Italics ours)

It was of course the fact that there was no discrimination that enabled the Court to sustain the income tax as applied to an exporter and to distinguish its decision from *Brown v. Maryland*, 12 Wheat. 419, where a license tax on the business of an exporter was held to be in effect a tax upon exports.

The present tax, though arrived at under the guise of an additional tax on net income, is in its ordinary application a tax solely on those dealing in state and municipal bonds, measured by the interest paid in carrying such bonds. It is the substance and effect that controls.

In the dissenting opinion in the National Life

Insurance Company case, Mr. Justice Brandeis (531) quoted the distinguished counsel for the amici curiae:

> "This allowance of a deduction of a fixed percentage, or 4 per cent of the mean of the reserve, itself points to the nature of the deduction, *not as a right, but as a favor.*" (Italics ours.)

In the present instance the deduction to which the limitation is sought to be applied is "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," or as it was considered below, "interest paid or accrued within the taxable year on indebtedness" incurred in respondent's business.

Neither of these deductions can be said to be a favor under the principle and terms of the revenue act.

2. *The tax exempt character of state and municipal bonds, can be wholly destroyed if the present tax is upheld.* This Court, speaking by Mr. Justice McReynolds, has said:

> "The suggestion that as Congress may or may not grant deductions from gross income at pleasure, it can deny to one and give to another is specious, but unsound. The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowance is the thing really taxed."

National Life Insurance Company, *supra,* page 520.

The object sought to be reached by the tax provi-

sion held invalid in that case and the object sought to be reached in the present case can in fact be reached in a variety of ways if this Court will permit the ingenuity of the legislature to override the constitutional inhibition. We do not believe that this Court will throw open the door to Federal taxation, discriminatory in character and discriminative in effect upon the instrumentalities of the states while at the same time as in its most recent decision (Macallen v. Massachusetts) protecting Federal instrumentalities and obligations from a non-discriminative burden or tax by state legislatures. If the Federal power extends to discriminative burdens, designed to offset constitutional inhibitions protecting state agencies and instrumentalites, then the corresponding power of the state must be equal to that of the Federal government.

It was, we understand, proposed some years ago, that the Congress might leave the income tax rates at their war levels, and *by separate act* "permit" taxpayers to make a "voluntary" return of interest received from state and municipal bonds, in which event the tax under the basic law should be limited to a lower named per cent flat or graduated, of the sum of (a) net income as returned and (b) tax free interest "voluntarily returned." The effect of such a proposal, if enacted and upheld, would be to *compel* the "voluntary" inclusion of interest of state and municipal bonds as a part of gross income.

Unless the constitutional inhibition, resting on the decisions of this court and upon the fundamental conceptions of our dual sovereignty, is a mere fiction, it cannot be evaded by a statute which while avoiding the appearance of a tax in fact levies a tax

upon the very thing that is and must be exempt. The unwritten constitutional principle looks to the substance. From its nature, it cannot be evaded by the written statute, however ingenious. *The governments, not the taxpayer, are primarily concerned in this matter.*

In the Macallen case, *supra*, at page 624, this Court quoted from Chief Justice Marshall in *Weston v. Charleston*, 2 Pet. 449, 468, a principle which "has never since been departed from by this Court,"

> "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence upon the contract. The extent of this influence depends on the will of a distinct government; to any extent, however, inconsiderable, it is a burden on the operations of government. It may be carried to an extent that will arrest them entirely."

Present counsel can see the practical aspects and value of such "permissive" deductions or limitations, granted "*not as a right, but as a favor.*" The same result would be effected in several ways. However effected, the burden upon the instrumentalities of the states and the corresponding state burdens upon federal instrumentalities, may be made precisely what it would be if the interest on their obligations were required to be included as gross income under the primary or basic provisions of the law. It is that burden, regardless of its form or of the ingenuity of legislation, against which this Court has heretofore protected the instrumentalities of the federal and state governments.

We respectfully submit, that independently of any

question of the validity of a general tax, state or federal, which includes or reaches municipal interest or other tax exempt income, there is no question, or should be none, that a discriminative burden, however effected, e. g. by inheritance or other excise tax, attempted to be laid by one government upon the officers, agencies, contracts, obligations or other operations or instrumentalities of the other, is unconstitutional. Macallen v. Mass., *supra.*

POINT II.

THE LAW PERMITS THE DEDUCTION OF INTEREST PAID BY A DEALER ON MONEYS BORROWED TO CARRY MUNICIPALS.

1. Paragraph (1) of Section 214 (a) authorizes the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." There is no limitation to this deduction. Under the plain reading of this paragraph a dealer is permitted to deduct interest paid as an expense of the business. The law, or any doubt in the law, is not to be construed in favor of the taxpayer, and the tax sought to be imposed must be within both the letter and the intent of the law. *U. S. v. Wigglesworth*, 2 Story 369, *Gould v. Gould*, 245 U. S. 151, 153, and cases cited, *Reinecke v. Trust Company*, 278 U. S. 339, 348.

It appears from the transcript that the respondent is a dealer in municipal bonds and that the interest sought to be deducted was in fact an "ordinary and necessary expense" of such business. The respondent deducted such interest in its original return. It was not necessary for the respondent in this case to attack the validity of the limitation against the

deduction of interest under paragraph (2). That paragraph applies only to the deduction of interest "on personal indebtedness as distinguished from business indebtedness"—we quote from the "instructions" found on page 3 of Form 1040 for the return of individual income for the year 1929. Despite its anomalous position on this appeal, the Internal Revenue Bureau has consistently followed the correct view of the law in the form used for the return of net income.

On the first page of the last prescribed form (No. 1040) of individual tax return for the year 1929, under "INCOME" we find

"2. Income from Business or Profession $....."
(From Schedule A)

Under "DEDUCTIONS" we find

"13. Interest Paid $.....
14. Taxes Paid $....."

On the second page we find

"SCHEDULE A—INCOME FROM BUSINESS OR PROFESSION
(See Instruction 2)",

under which, after "total receipts", cost of goods sold", etc., we find:

"Other Business Deductions

11. *Interest on business indebtedness to others,* $.....
12. *Taxes on business and business property,* $.....

and finally:

"19. Net profit * * * (enter as Item 2) $....."

On the third page entitled

"INSTRUCTIONS", we read,

"The Instructions Numbered on this page correspond with the *item numbers* on the first page of the return."

Under

"2. Income from Business or Profession", referring to Schedule A. we note:

"Enter on *line* 11 interest on business indebtedness to others. *Do not include* interest to yourself" etc.

We do *not* find any instruction "do not include" interest on indebtedness incurred to purchase tax-free obligations.

At this point, it is clear that the taxpayer, following the instructions, has made a complete deduction of *all* interest paid on business indebtedness.

Under "13. Interest paid", we read:

"*Enter as item 13 interest paid on personal indebtedness as distinguished from business indebtedness (which should be deducted under Schedule A or B). Do not include interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation.*" (Italics ours.)

Schedule B covers "rents and royalties", as to which also of course there may be interest paid.

In other words the Bureau itself in its prescribed form recognizes and requires the necessary distinction to be made between interest paid on business indebtedness under Schedule A including the deductions authorized by paragraph (1) of the law, and interest paid on "personal indebtedness" under Item 13, the deduction allowed by paragraph (2) of the law. There is no restriction on the deduction of interest paid on business indebtedness under Schedule A. This restriction is found only under Item 13 and affects only the deduction of "interest paid on personal indebtedness as distinguished from business indebtedness." Likewise, of course, "taxes paid" on business indebtedness are deductible under Schedule A, *i. e.*, under paragraph (1) and taxes deductible under "item 13", *i. e.*, the separate paragraph (3), include only taxes on property not used in business.

Substantially the same form and instructions were used for the year 1922, presumably by the taxpayer in the present case.

Clearly, if the position contended for on this appeal is correct, the required form of return is wrong. It is wrong and confusing not only in detail, but in requiring a separate statement of business income. If interest can only be deducted under paragraph (2), and taxes under paragraph (3), then any business income sought to be arrived at under Schedule A must be partial and fictitious. Only that which has the nature of income can be taxed and "the construction of the act (is) inseparable from the interpretation of the Sixteenth Amendment." *Eisner v. Macomber*, 252 U. S., 189, 202; *Doyle v. Mitchell*, 247 U. S. 179.

The allowance of the deduction of all interest as an

expense of the business under paragraph (1) is not only within the plain reading of the law. It is in keeping with the principle and purpose of the law, to tax net income, saving only that which is not constitutionally taxable. Any other reading of the law would, in the case of a dealer, levy a tax on interest paid to offset, it would seem, the exemption allowed on interest received. It would not, as in the case of "interest paid on personal indebtedness", *i. e.*, outside of a normal business, be directed to the deliberate avoidance of the tax on otherwise taxable income.

The Government's position is that the limitation in paragraph (2) applies to paragraph (1) by analogy with the operation of clauses first and third in the second paragraph of Section 38 of the Corporation Tax Act of 1909, as applied in *Anderson v. Forty-two Broadway Company*, 239 U. S. 69, page 71. The "special circumstances" under the 1909 Act had reference in part to a clause not found in the revenue acts. The resemblance of the 1921 paragraphs to the 1909 clauses is more apparent than real, even if we ignore the fact that we are now dealing with a tax on all incomes, individual and corporate, where the purpose and interpretation of the act follow the power under the XVIth amendment, and not solely with a corporation excise tax under the plenary power. The only business expenses deductible under the first clause in the 1909 Act were those paid "*in the maintenance and operation of its business and properties*" and the added clause, "including all charges such as rentals or franchise payments" etc., emphasized the purpose of the clause to reach what is generally recognized as "operating income." The separate interest deduction "*on bonded* and other indebtedness not exceeding the paid-up capital

stock" could have had no effect at all unless as this Court held in the Forty-two Broadway case it applied to bonded debt and, as the Court seemed to consider, was directed in purpose and principle to interest on indebtedness in the nature of capital indebtedness, and designed to make the tax reach a corporation which with a huge debt and small capital was in fact "conducted more for the benefit of the creditors than of the stockholders." The purpose of the act was plain and beneficial, to prevent the avoidance of the tax. This was no longer possible when both corporate income and individual income became taxable under the same law. The interpretation urged by the taxpayer under the 1909 act would, of course, have enabled the owners of a corporation to avoid the tax by doing business on money loaned to it by themselves.

We do not believe that the reading and necessary intent of the 1909 act will be held to control the interpretation of the later revenue acts which beginning with 1913 were new enactments under the new constitutional amendment. In particular the limitation in clause first, "in the *maintenance and operation* of *its business*" found in the corporation act of 1909 in connection with the separate deductions there specified, cannot be read into paragraph (1) of the individual deduction sections of the revenue acts where the phrase is *broad and general "in carrying on any trade or business"* and plainly, as evidenced by Form 1040, permits the complete deduction of all business expenses including interest. More could be said on this, but it seems clear that the very special purpose of the 1909 act, properly upheld in the Forty-two Broadway case, has long since been served, and that the later provision now found in the revenue acts

of 1921 and later years should be given their natural interpretation. To hold otherwise in this case is to tax something that is not income and has not the nature of income,—the interest paid by dealers in carrying bonds for sale.

2. To hold that interest paid cannot be deducted under paragraph (1) raises a constitutional question of great difficulty. This question should be avoided. We have covered it under Point I. We wish, however, to point out the important distinction in the limitation as applied to a dealer. A careful reading of the opinion below, particularly the statement in the final paragraph, that "such disallowance", of the deduction of interest under paragraph (2) "cannot be given effect in the present case", indicates that the Court read into paragraph (2) a constitutionally necessary exception where there was no purpose of tax avoidance. In his brief supporting petition for writ the Attorney General said that the restriction "is justified by the practical necessity of preventing such borrowings for the purpose of evading the tax on other income." For argument, it might be conceded that the limitation in paragraph (2) could be upheld as a quasi penal provision, applied and limited to the purchase of tax-free bonds on borrowed money for the deliberate purpose of avoiding the income tax. An investor or speculator with an otherwise taxable income of $50,000, may conceivably carry $1,000,000 4% tax-free bonds on borrowed money, paying $50,000 interest. Under very favorable circumstances he might carry $2,000,000 with a tax-free income of $80,000 and pay 2% to 3% and have both a profit on the transaction and no tax to pay on his otherwise taxable income. The more instances we assume,

however, the less feasible in practice such tax avoidance appears except perhaps under very high tax rates. The trouble, cost and risk are deterrent. But in theory the chance of tax avoidance is there and it may be would justify some possible provision to prevent it. It is notorious that the present provision is readily evaded by wealthy investors; *e. g.*, they can borrow money on railroad bonds or real estate and buy municipal bonds. Such tax avoidance can be readily effected to day by carrying preferred and common stocks on borrowed money, but we doubt if many taxpayers purposely avail themselves of it.

But such is not the state of facts in the present suit. We have to do with the operation of the law and constitutional inhibition as applied to an active dealer engaged in a normal and necessary business, a business essential to the advantageous marketing of state and municipal bonds. There is no suggestion of tax avoidance, but of whether or not the Congress has, in the case of the dealer, intended to tax interest paid, or can tax it constitutionally, simply to offset the exemption on tax-free interest received resulting from the constitutional inhibition.

As applied to such normal business, the constitutional tax exempt character of municipals is, as in the case of the investor purchasing for investment (not on borrowed money) a normal and necessary result of the constitutional inhibition. There is no attempt at tax avoidance. Tax immunity, partial or entire, of a dealer, results from the constitutional inhibition, from its necessary application to a business so directly concerned with the marketing of state securities. Whatever tax avoidance or escape

from tax results to the dealer, there is in fact or by presumption no resort to a device to avoid the tax.

Also, as in the case of the investor, the benefit or burden enures to the states and their subdivisions, a fact to be presumed in view of the very special character and heavy incidence of the tax and the extremely competitive nature of the business; the tax or tax saving is a factor which can be measured on every purchase.

As stated, the incidence of this tax, as claimed, lying directly upon the amount of interest paid, falls upon a normal business essential to the successful marketing and competitive distribution of state and municipal obligations. As to this business, the tax is definitely discriminatory, in terms and in effect. In passing, the Court will note that dealers buying and selling stocks of corporations, common and preferred, are partly—*corporate dealers wholly*—exempt from any tax on dividends received while the stocks are carried—1928 Act, Sec. 23(p) and 25(a)—and yet they are permitted to deduct all interest paid in carrying such securities.

CONCLUSION.

We respectfully submit:

(1) That the additional tax sought to be imposed is in purpose and effect a tax, not upon income, but upon interest paid by dealers in purchasing and carrying state and municipal bonds for distribution to investors.

(2) That it is a direct and discriminative burden upon the instrumentalities of the states and, if

authorized by the law, would be unconstitutional.

(3) That the tax is not authorized by the law; the deduction of interest paid by dealers is permitted by paragraph (1) of Section 214 (a); any doubt must be resolved in favor of the taxpayer; and the Court will if possible construe the act to avoid the serious constitutional question presented by respondent.

FRED H. DAVIS,
Attorney General of the State of Florida.
ROBERT R. REED,
Counsel for George B. Gibbons and Company, Inc.,

IN THE

Court of Claims of the United States

No. L-422.

GEO. B. GIBBONS & CO. INC., a corporation,
against
THE UNITED STATES OF AMERICA.

PETITION.

(Filed October 14, 1930.)

To the Court of Claims of the United States:

The petitioner, Geo. B. Gibbons & Co. Inc., hereinafter called the claimant, respectfully shows:

1. At all times hereinafter named, the claimant was and is a domestic corporation organized and existing under the laws of the State of New York engaged in the business of investment banking, being the original purchase of bonds and notes issued by states or their political subdivisions and the resale and distribution of such securities to their customers and having an office and principal place of business at 40 Wall

Street, Borough of Manhattan and City of New York, except that since May 1st, 1929, claimant's office has been and now is at 49 Wall Street, in such Borough and City.

2. To secure the additional capital necessary to purchase such securities and to carry them pending their sale, the claimant in its regular course of business, and according to the regular course of business of all dealers in such securities, borrows a large amount of money from one or more banks and deposits with such banks the securities which it has purchased and is holding for sale, increasing or diminishing such loans from time to time as securities are purchased and sold, and is required to pay interest on such loans according to the rates prevailing from time to time and charged to it by such banks.

3. During the calendar years 1926, 1927 and 1928, respectively, the claimant paid as interest on such loans, being interest paid to purchase and carry obligations issued by states and their political subdivisions pending the sale thereof, as aforesaid, which obligations were purchased by claimant and thereafter resold by it, the following sums:

1926, $64,723.49, being at the average rate of 4.51 per centum per annum,
1927, $52,836.82, being at the average rate of 4.22 per centum per annum,
1928, $50,596.85, being at the average rate of 5.12 per centum per annum,

That all of said moneys were paid by claimant in the ordinary and necessary course of its business and con-

stituted ordinary and necessary expenses of such business. That none of such obligations were purchased or carried by claimant for investment or otherwise than as stated, to wit: for sale in the course of the claimant's business.

4. That thereafter and in due course the claimant made its income tax return for each of said years and in determining its net income the claimant deducted the ordinary and necessary expenses of its business, including the amounts so paid as interest in carrying such securities. Such deductions were made under the Revenue Act of 1926, paragraph (1) of subsection (a) of Section 234, and under the Revenue Act of 1928, paragraph (a) of Section 23.

5. That thereafter upon the audit of the claimant's said income tax returns, the Commissioner of Internal Revenue erroneously and illegally assessed the claimant an additional tax for each of said years, to wit: for the taxable year 1926 (excluding a small amount based on other grounds which claimant has waived) $8,966.31 with interest, for the taxable year 1927 $7,402.97 with interest, and for the taxable year 1928 $1,431.38. Such amount in each case being the amount of additional tax, with interest, which would have been due by claimant if the claimant's net income had been increased by the amount of interest which it had paid as above stated and such additional assessment in each case was based solely on the elimination by the Commissioner of the deduction of interest paid by claimant for the years and in the amounts above named to purchase and carry obligations issued by states and their political subdivisions, even though

as stated such payments were made in each instance as an ordinary and necessary expense of claimant's business under the above recited paragraphs and provisions of the Revenue Acts of 1926 and 1928. The Commissioner claiming that such deductions even though made under the paragraphs and provisions above recited as a part of the expenses of claimant's business were in some way or for some reason affected by the restriction or exception to the deduction of interest when claimed under paragraph (2) of subsection (a) of Section 234 of the Revenue Act of 1926 or paragraph (a) of Section 23 of the Revenue Act of 1928, though claimant during said years neither borrowed money nor paid interest outside of its trade or business and therefore had no occasion to make or claim any deduction of interest under the last recited paragraphs. Claimant simply followed the order and natural reading of the law and deducted all its business expenses under the paragraphs relating to such expenses. It made or claims no deduction under the later paragraphs. Nowhere in such Acts, or either of them, is there any restriction or limitation to the deduction of ordinary and necessary expenses of the business, otherwise the tax would rest upon the gross receipts or turnover of a mercantile business and as claimant is advised, would not be valid as an income tax, nor would the amount so determined be within the definition of gross income as found in Section 22 (a) or within the terms or intent of the above recited Revenue Acts.

6. The taxpayer was and is a dealer in state and municipal securities. Substantially all of the obligations issued by states and municipalities are sold to

dealers in such securities, generally on competitive bidding and are taken up and carried by the dealers until they are retailed to their customers. All such dealers as a matter of practice and necessity borrow the larger part of the moneys used by them to purchase and carry such securities. Such money is necessarily borrowed from the banks at current rates. Such loans are short time or call loans and the interest rate has no direct market relation to the rates paid on the securities carried. To prohibit the deduction of interest paid by dealers in carrying such securities for resale, imposes a direct and serious burden on the purchase and sale thereof by the dealers and this burden substantially reduces the prices paid by dealers for such securities and materially impairs the power of states and municipalities to sell their bonds. This burden becomes very marked in periods of high money rates when dealers hesitate to purchase such obligations and even withdraw from competition in the purchase thereof because of such high rates and because they are in effect taxed upon the amount of interest paid. A corporate dealer having in fact no profit for the taxable year is taxed 13½ per cent on say $500,000 paid in carrying tax exempt securities. He may have received $300,000 or $400,000 tax-free interest on such securities. Dealers buy and sell such obligations for the profit and the profit on the resale thereof is held to be taxable. The interest paid to purchase and carry the obligations is paid as an expense of the business in order to realize such taxable profit.

The taxpayer claims (1) that the additional assessment imposed upon it in the amounts and for the years stated above is unauthorized by the statute

and (2) that such assessment if authorized is unconstitutional. This assessment, despite its terms, is levied in fact upon the amount of interest paid by the dealer in carrying on his normal business. It imposes a direct, substantial and confiscatory burden on this business. This business is highly competitive. Many active investment dealers enter and leave the municipal business or buy few or many issues, as conditions change. Bonds are often authorized by statute or ordinance to be sold at not less than par bearing a limited rate of interest, and cannot be sold at all if the burdens imposed on the business are such as not to permit their purchase and sale within such limits at a possible profit. In such cases the discriminatory burden on dealers makes it impossible for the states and municipalities to dispose of their bonds and to carry out the governmental object for which such bonds are authorized and in all cases reduces the price of bonds and increases the interest cost of the borrowing and of the object for which the bonds are authorized. The tax itself is shifted to the states and their political subdivisions. Correspondingly whatever benefit there may be in the fact that the interest received on such securities is tax exempt to the dealers is received by the states and municipalities which issue them. The burden or benefit, varying with the market, is that of the governmental interests and functions affected.

7. That for the taxable year 1928 the petitioner received interest on obligations issued by states and municipalities which obligations were purchased with the money borrowed as aforesaid only the sum of $41,011.09, being at the average rate of 4.15 per cent,

and paid interest to carry such obligations in the sum of $50,596.85. Excluding the interest received as aforesaid the petitioner reported a net loss for such year of $35,668.68. Including such interest, it had in fact a net income of $5,342.41 which, less the $3,000 credit, would if taxable have been taxed in the sum of $281.09. The Commissioner eliminated the deduction of $50,596.85 representing interest paid and found and taxed as net income the sum of $14,928.17, which, less the $3,000 credit, makes the tax paid by petitioner $1,431.38, an amount exceeding by $1,250.29 the tax which it would have paid had the interest received on such obligations been included as gross income. That such tax is not on net income because there was none. That it is not upon gross income because the selling price of merchandise is in no legal sense gross income to a merchant. That under the law, as interpreted and enforced, by the Commissioner such tax paid for the year 1928, as well as the similar tax for the years 1926 and 1927 as above recited, is a tax on the interest paid by a dealer in carrying such obligations for sale and as such is unconstitutional as a burden on the instrumentalities of a state and as a direct tax made without apportionment. It is also, as petitioner is advised and believed, not within the intent of the act, the dominant purpose of which is to tax net income and in the case of a trade or business to permit the deduction of all ordinary and necessary expenses for the purpose of determining such income.

8. That such tax imposed on dealers in carrying such obligations for sale is further discriminatory and burdensome on the marketing of such obligations

and on the instrumentalities of the states and their subdivisions in that it singles out such obligations for such burden and in particular that no such burden or restriction is imposed on the purchasing and carrying of other obligations issued by railroads and industrial corporations or of preferred and common stocks, although in the case of stocks, the income derived therefrom in the form of dividends is wholly exempt from taxation when received by a corporate dealer, such as the petitioner, and is exempt from the normal tax when received by an individual.

9. The Commissioner duly demanded the payment of such additional tax, which demand was made in due form of law, and the claimant, being advised and believing that its property would be seized if it failed to pay upon such demand, paid the same under protest, to wit: on April 21st, 1930, the claimant under compulsion as aforesaid paid to the Collector of Internal Revenue for the Second New York District of New York City, N. Y., the sum of $10,566.36, as an additional income tax for the year 1926, being $8,966.31 with interest to such date, the sum of $8,279.87, as an additional income tax for the year 1927, being $7,402.97 with interest to such date, and the sum of $1,515.05, as an additional income tax for the year 1928, being $1,431.38 with interest to such date, such additional tax in each of said years being based solely on the elimination of the deductions claimed by claimant representing interest paid as an ordinary and necessary expense of claimant's business, as above recited, although on such date claimant paid or had paid his income taxes for each of such years in full and owed no additional tax

whatsoever. That the said Collector, as claimant is advised and believes, turned over said moneys in due course of official business and deposited the same in the Treasury of the United States of America.

10. Thereafter in due form as permitted by law, claimant on May 5th, 1930, filed with the said Collector a claim for the refund of the amounts so paid, to wit: $10,566.36 for the year 1926, $8,279.87 for the year 1927 and $1,515.05 for the year 1928, paid on April 21st, 1930, which claim for refund set forth the facts substantially as above recited and duly demanded the refund of the illegal payments made as aforesaid. Thereafter in due form of law the said Collector on July 25, 1930, rendered his decision disallowing such claim for refund and so notified claimant.

11. No other action than as aforesaid has been had on this claim in Congress or by any of the Departments. The claimant has at all times borne true allegiance to the Government of the United States. It has not in any way voluntarily aided, abetted, or given encouragement to rebellion against such Government. It is and always has been the sole and absolute owner of the claim here presented. It has made no transfer or assignment of said claim or of any part thereof or of any interest therein. It is justly entitled to the amount claimed from the United States of America, after allowing all just credits and set-offs.

12. The claimant believes the facts as hereinabove stated to be true.

WHEREFORE, the claimant prays judgment against the United States of America upon the facts and law for $20,361.28, together with interest thereon from April 21st, 1930, and its reasonable costs and disbursements herein.

GEORGE B. GIBBONS & COMPANY, INC.,
Claimant.

By GEORGE B. GIBBONS,
As its President.

JOHN E. WALKER,
Attorney for Claimant.

State of New York, County of New York, ss.:

GEORGE B. GIBBONS, being duly sworn, deposes and says:

I am the President of George B. Gibbons & Company, Inc., the claimant above named. I am well acquainted with its business. I have read the foregoing petition and know its contents. The same is true of my own knowledge except as to the matters therein stated upon information and belief and as to those matters I believe it to be true.

GEORGE B. GIBBONS.

Subscribed and sworn to before me, this 6th day of October, 1930.

H. L. DIETZ,
Notary, Public, Westchester County.

Certificate filed in New York County.
New York Co. Clerk's No. 428.
Commission expires March 30, 1932.

SUPREME COURT OF THE UNITED STATES.

No. 60.—October Term, 1930.

F. G. Denman, Administrator of Charles H. Nauts, Collector of Internal Revenue, Petitioner, vs. W. L. Slayton.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[February 24, 1931.]

Mr. Justice McReynolds delivered the opinion of the Court.

During the year 1922 while respondent Slayton engaged in the business of buying, carrying and selling tax exempt municipal bonds he collected $65,720.06 as interest on securities of that character which he owned. He paid out $78,153.84 for interest on money borrowed by himself in due course for the purpose of purchasing and carrying exempt securities. In his return showing income received during that year he excluded the interest so collected, and he claimed deduction for the interest paid out on the borrowed money. The Commissioner disallowed the deduction and made a corresponding additional assessment. Respondent paid the sum demanded thereunder and after proper preliminary action sued to recover it.

Determination of the question involved must turn upon the validity, construction and effect of Sections 213 and 214, Revenue Act of 1921, 42 Stat. 227, 237, 238, 239. Their pertinent provisions follow:

> Sec. 213. That for the purposes of this title . . . the term "gross income" . . .
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> 1. Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;
>
> Sec. 214. (a) That in computing net income there shall be allowed as deductions . . .

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . . .

By original petition in the District Court, Northern District of Ohio, Slayton asserted that the exception found in paragraph (2), Sec. 214 (a), conflicts with the Federal Constitution in that by necessary operation it causes discrimination against the owners of non-taxable securities and nullifies their immunity from taxation. Also that the act is discriminatory and unconstitutional in that necessary expenses incident to all other kinds of business, including interest paid for purchasing and carrying merchandise and inventories, are allowed as part of the operating cost, whereas deduction of interest paid by plaintiff upon funds borrowed to carry non-taxable securities (an ordinary operating expense) is prohibited. Also that the act is arbitrary and unconstitutional because it discriminates against plaintiff whose resources do not permit him to purchase tax free securities for cash and in favor of those whose resources permit them to purchase and carry such securities without borrowing.

The Collector unsuccessfully demurred to the petition upon the ground that it states no cause of action. Judgment went for the plaintiff and was affirmed by the Circuit Court of Appeals. Both courts were of opinion that under the doctrine announced in *National Life Ins. Co.* v. *United States*, 277 U. S. 508, enforcement of paragraph (2), Sec. 214 (a), would deprive respondent of rights guaranteed by the Federal Constitution.

The challenged judgment must be reversed. The case will be remanded to the District Court with instructions to enter judgment for the Collector.

The circumstances disclosed in *National Life Ins. Co.* v. *United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest

from tax free securities—a result which we found would have followed enforcement of the literal provisions of Sec. 245 (a), Revenue Act 1921, 42 Stat. 227, 261. While guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed.

The manifest purpose of the exception in paragraph 2, Sec. 214 (a), was to prevent the escape from taxation of income properly subject thereto by the purchase of exempt securities with borrowed money.

Under the theory of the respondent, "A", with an income of $10,000 arising from non-exempt securities by the simple expedient of purchasing exempt ones with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility. The classification complained of is not arbitrary, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress. The fact that respondent engaged in the business of buying and selling is not important. See *Willcuts, etc.* v. *Bunn*, decided January 5, 1931.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.